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A.I.D. AND ECONOMIC POLICY REFORM:

ORIGINS AND CASE STUDIES

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INTRODUCTION: THE ROLE OF A.I.D. IN ECONOMIC POLICY REFORM

It was the administration of President John F. Kennedy that first emphasized the need for economic policy reform as a vital part of the U.S. effort to reduce world poverty. Economic reform was a part of the mission of the Agency for International Development (A.I.D.) created in 1961. Unfortunately, subsequent administrations eroded this important legacy of President Kennedy. Nevertheless, in the three decades since 1961, a small minority of A.I.D. officials (including many economists) struggled to continue the work of economic policy reform.[1] Their efforts are little known. Congress requires no reports about them. There is no formal budget for "policy reform."[2] A.I.D. has been omitted from the hundreds of books and articles about economic reform in the developing nations, and the credit usually goes to the national leaders who carried out the reforms. While A.I.D. has maintained a tactful silence, the contributions of the IMF and the World Bank have been described in considerable detail.[3] Today, therefore, few know of the "success stories" of A.I.D. in promoting economic

[1] A.I.D. employs two thousand American officials in Washington and another one thousand overseas who manage about two thousand separate aid "projects" in nearly one hundred nations. "Projects" seldom deal with economic policy reform. Instead, policy reform is the subject of negotiations, known as the "policy dialogue, with the host nation's highest leadership. Thus, this report examines only a tiny portion of A.I.D.'s activity.

[2] A proposal in 1993 suggested that A.I.D. be restructured into three bureaus, one for "basic human needs," one for "gifts" for security purposes, and one solely for "policy reform." See Anne O. Krueger, Economic Policies at Cross-Purposes, Washington, D.C.: The Brookings Institution, 1993, pp. 188-190.

[3] However, descriptions of some aspects of A.I.D. will be found in these studies. See Legislative Reference Service, Library of Congress, U.S. Foreign Aid: Its Purposes, Scope, Administration, and Related Information, Washington, D.C., Government Printing Office, 1959; Joan Nelson, Aid, Influence and Foreign Policy, New York, 1968; H. Field Haviland, Jr.,"Foreign Aid and the Policy Process: 1957," American Political Science Review, September 1958; Frank Coffiin, Witness for Aid, Boston: Houghton Mifflin, 1964; Kenneth M. Kaufman and Helena Stalson, "U.S. Assistance to the Less Developed Countries, 1956-65", Foreign Affairs, July 1967; Edward S. Mason, Foreign Aid and Foreign Policy, New York, Harper, 1964; Merilee S. Grindle and John W. Thomas, Public Choices and Policy Change: The Political Economy of Reform in Developing Countries, Johns Hopkins University Press, 1991.

reform during and after the Kennedy years. This report, based on interviews with A.I.D. and developing country officials and a review of internal A.I.D. documents, attempts to capture the history of thirteen of those efforts in sufficient detail to illustrate what A.I.D. did and what results it obtained. Three cases are from the Kennedy-Johnson era. Eight are from the past decade. Eight are from Latin America.

What were the reasons for the erosion of the Kennedy emphasis on economic policy reform? Several answers will be offered. At the heart of the issue is the inherently controversial and complex nature of any effort by the American government to interfere in the economic policy preferences of the developing nations, other than by simply providing unconditional cash grants or delivering tangible aid such as food, technology or famine relief.

Many cautious American diplomats believe that promoting economic reform may be a good thing in principle, but it is too controversial for a bilateral approach, and so should certainly be left solely to multilateral institutions like the World Bank and IMF. This view is correct to assume that it is hard to avoid some friction when A.I.D. officials interfere, in the name of reform, in the economic policies of aid recipients, even if successful reform eventually helps to save lives and to alleviate poverty in the developing nations.

A second cause for erosion has been the lack of a Congressional interest in economic policy reform. Congress has few economists, and foreign aid has never been popular. A.I.D. can only do what Congress authorizes, and there have never been any funds earmarked for economic reform, even though Congress provides very detailed instructions for how A.I.D. must spend its annual budget. In fact, although Congress has mandated in vague terms that A.I.D. should assist poor nations to improve their economic growth, Congress has failed to specify how or when A.I.D. should insist upon economic policy reform. As the case studies will demonstrate, economic reform is difficult to promote, so Congressional silence about it is all the more disappointing.

A third cause for erosion has been the intense competition for resources within A.I.D. Dozens of budgetary approaches to aiding the word's poor nations are frequently highlighted in public releases about A.I.D.'s work, but rarely is policy reform included. In fact, the degree to which the Kennedy legacy has been eroded was demonstrated in 1991. The thirty year anniversary of A.I.D.'s creation in 1961 by President Kennedy was commemorated without mention of policy reform by the Administrator of A.I.D. Similarly, it was not surprising that Congress took no official notice of the controversial decision by President Bush's A.I.D. Administrator not only to eliminate the Office of Economic Analysis and to abolish the position of Chief Economist at A.I.D., but also to fail to even mention economic policy reform in his public speeches and Congressional testimony.

THE DEFINITION AND IMPORTANCE OF ECONOMIC POLICY REFORM

The origins of the idea of economic development among the poor nations in the world has been traced by a number of scholars.[4] It did not exist prior to 1940. Even today, there is no precise formula agreed upon by economists that can be rigidly applied to judge the quality of a developing nation's economic policy. One early formula was too general to apply in specific cases of hard choices. Professor (and Nobel laureate) Arthur Lewis wrote, "The central problem in the theory of economic growth is to understand the process by which a community is converted from being a 5 percent to 12 percent saver (investor) -- with all the changes in attitudes, in institutions and in techniques which accompany this conversion."[5] Taiwan, the first of this report's case studies, succeeded in raising its savings rate from 5 percent in 1952 to 13 percent in 1963, surpassing both the U.S. and U.K. rates of about 9 percent; and by 1971 Taiwan surpassed Japan's savings rate of 20 percent (which used to be the world's highest), and by 1978 it achieved a 35 percent savings rate. Yet many poor nations have still not achieved such a high savings rate.

There may be no simple definition of economic policy reform. It is obviously a process that begins when national leaders decide to change laws and regulations so that a slowly growing economy grows at a faster rate. How to do this well is not simple. Economists cannot define precise links between a country's growth rate and its entire package of laws, decrees, administrative measures, and judicial constraints. However, in 1983, an experienced adviser on economic reform to many nations, Professor Arnold Harberger,

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[4] H.W. Arndt, Economic Development. The History of an Idea, University of Chicago Press, 1987.

[5] W.A. Lewis, The Theory of Economic Growth, London: Allen and Unwin, 1955, p. 195.

suggested several goals that define successful reform. Harberger's lessons are similar to later findings by the World Bank and A.I.D. about which policies trend to bring high growth rates.[5]

Professor Harberger's Economic Reforms

1. **Keep inflation low**
2. **Keep budget deficits low**
3. **Avoid overvalued exchange rates**
4. **Keep tariffs and trade barriers low**
5. **Maintain simple tax systems**
6. **Avoid excessive tax rates**
7. **Minimize subsidies**
8. **Make public enterprises efficient**

Few developing nations have implemented all reforms. Unfortunately, many poor nations have yet to implement any. Foreign aid to such unreformed nations helps to some degree, but would help many times more if their economies were efficient. Those who care about reducing world poverty have an interest in learning which nations are the unreformed ones that need help to become more efficient. Ignoring widely accepted, non-partisan economic principles is no way to reduce world poverty that affects one billion people.[7]
In 1991, the World Bank's Annual Development Report illustrated how large a contribution

[6] Arnold C. Harberger, "Introduction," in World Economic Growth, edited by Arnold C. Harberger, San Francisco: ICS Press, 1984, p. 6.

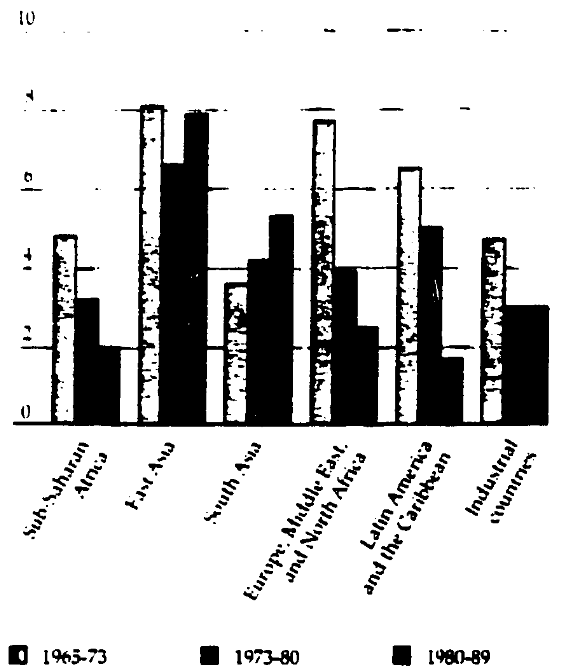
[7] There is no official list of "unreformed" nations which are not yet effectively reducing human poverty.

economic policy reform can make to reducing world poverty.[8] Several charts help illustrate the importance of economic reform.

[8]The Bank is careful in its report to state that in addition to policy reform other measures are also needed to fight world poverty such as: 1) more capital transfers to poor nations, 2) reducing barriers to the exports of developing nations, 3) transfer of technology through trade and 4) encouraging spending on programs that build a social safety net for the poor, and 5) more emphasis on primary education, because adding three years of education to a nation's work force may boost its GNP by 27 percent, 6) reduction of military spending, and 7) debt forgiveness for very poor nations.

Figure 1.5 Estimates of the growth of GDP, 1965-89

percent



Note: GDP estimates are least-squares in real terms.
Source: World Bank data.

Per capita growth performance of developing economies and territories, 1950–85

Negative growth	Positive but insignificant growth	Positive and significant growth
Afghanistan	Argentina	Algeria
Angola	Bangladesh	Barbados
Benin	Chile	Botswana
Bolivia	Congo	Brazil
Burundi	Côte d'Ivoire	Burkina Faso
Central African Republic	El Salvador	Cameroon
Chad	Ethiopia	China
Ghana	Fiji	Colombia
Guinea	Guatemala	Costa Rica
Guyana	Haiti	Cyprus
Madagascar	Honduras	Dominican Republic
Mali	Jamaica	Ecuador
Mozambique	Kenya	Egypt
Senegal	Liberia	Gabon
Somalia	Mauritania	Hong Kong
Sudan	Mauritius	India
Zaire	Nepal	Indonesia
Zambia	Nicaragua	Jordan
	Nigeria	Korea
	Papua New Guinea	Lesotho
	Peru	Malawi
	Philippines	Malaysia
	Rwanda	Malta
	Sierra Leone	Mexico
	The Gambia	Morocco
	Togo	Myanmar
	Uganda	Pakistan
	Uruguay	Panama
		Paraguay
		Singapore
		South Africa
		Sri Lanka
		Suriname
		Swaziland
		Syria
		Taiwan Prov of China
		Tanzania
		Thailand
		Tunisia
		Turkey
		Zimbabwe
18	28	41

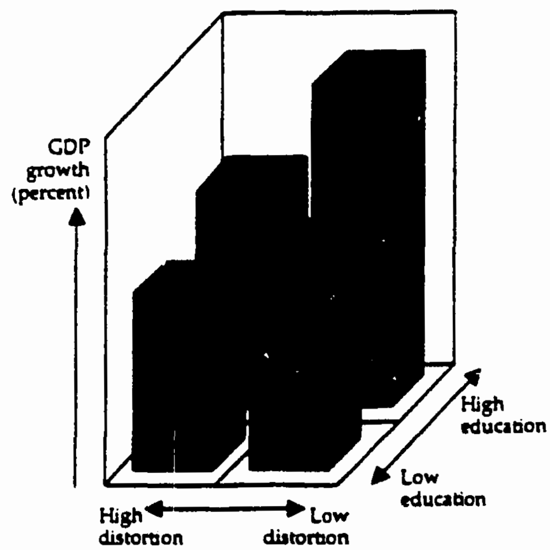
Source: Summers and Heston data set, *Review of Income and Wealth*, March 1988.

Figure 1.5 contrasts the sharp declines from 1965 to 1989 in three "less reformed" region's economic growth rates (Africa, Latin America and the Middle East) to the high steady rates in East Asia, where policy reforms were implemented in the 1960s.

The box shows that from 1950 to 1985, only 41 of 87 so-called "developing" nations have actually been "developing" with "positive and significant growth" on a per capita basis. 18 had smaller economies after 35 years as so-called "developing" nations, 28 had "insignificant" growth, not sufficient on a year-to-year basis to identify an upward trend.

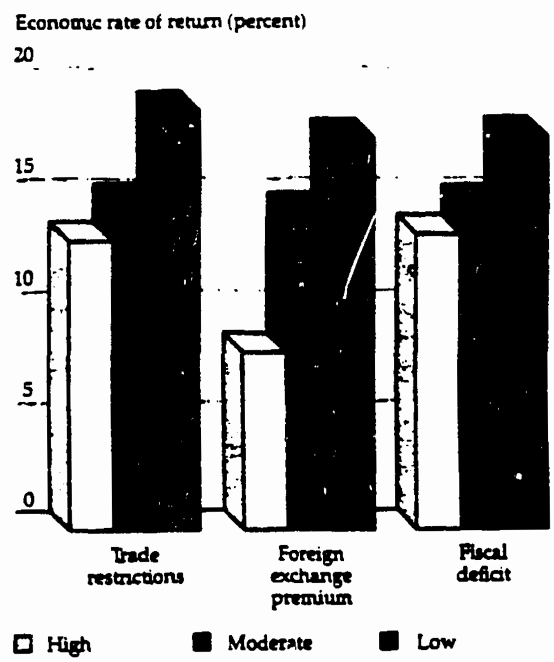
The World Development Report 1991 analyzes how failure to reform economic policy is responsible for the slow or zero growth rates that tend to increase world poverty.

Figure 3 Policy distortion, education, and growth in GDP, sixty developing economies, 1965-87



Note: High distortion reflects a foreign exchange premium of more than 30 percent; low distortion, a premium of 30 percent or less. Education is measured by the average years of schooling, excluding postsecondary schooling, of the population age fifteen to sixty-four. High education is defined here as more than 3.5 years; low education, 3.5 years or less. For the derivation of data, see Table 2.4.
Sources: International Currency Analysis, Inc., various years; World Bank data.

Figure 5 Rates of return for projects financed by the World Bank and the IFC under different policies and conditions

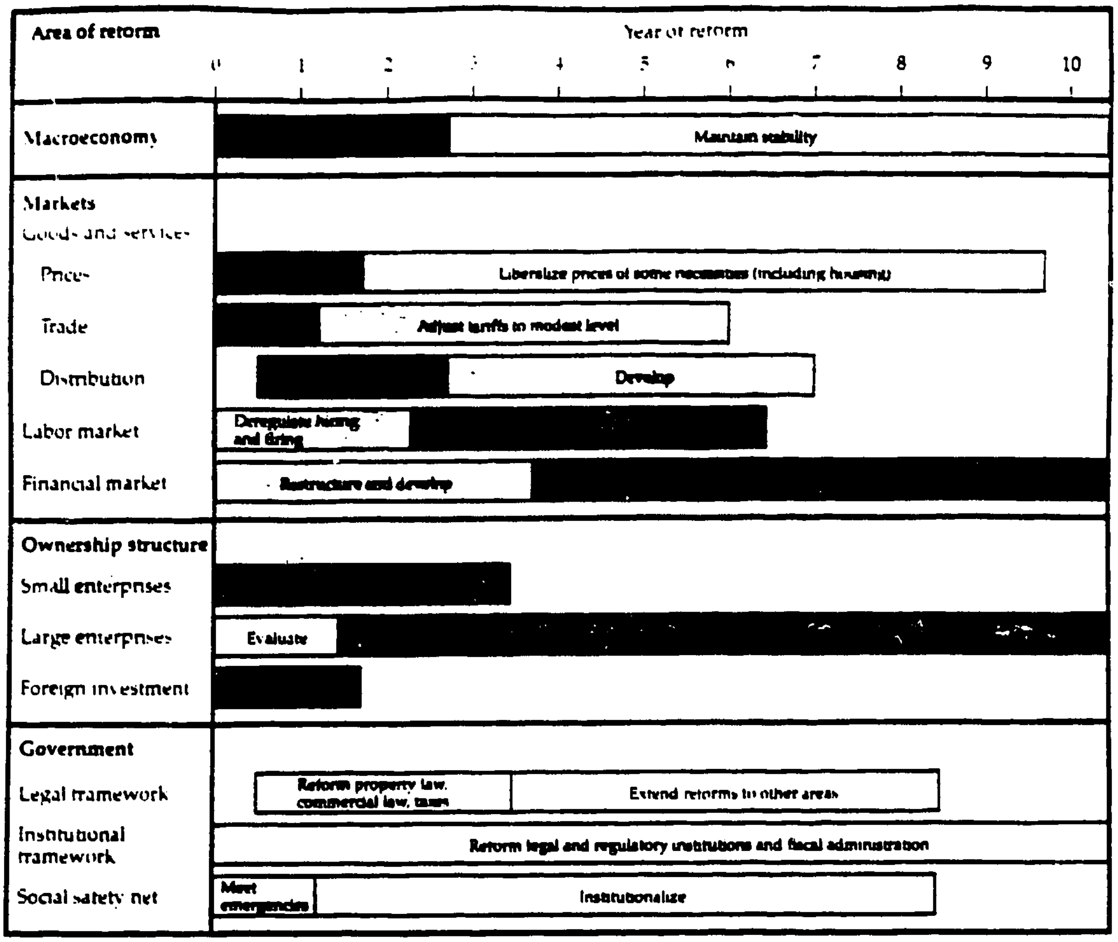


Note: Calculated for 1,200 public and private projects. A high foreign exchange premium is more than 200 percent; moderate, 20-200 percent; low, less than 20 percent. A high fiscal deficit is more than 8 percent of GNP; moderate, 4-8 percent; low, less than 4 percent. For explanation of trade restrictions, see the technical note for Chapter 4 at the end of the main text.
Source: World Bank data.

Figure 3 shows that in 60 developing nations from 1965 to 1987, higher growth rates resulted from more realistic foreign exchange rates and from educational spending that provided more than 3.5 years schooling. Nations which combined both policies attained average economic growth increases of 5.5 percent, nearly double the growth rate of nations with low education and highly distorted exchange rates.

Figure 5 presents the results of a study of 1,200 World Bank projects which suggests that the benefits of a project may nearly double when a nation's economic policy is good. A realistic foreign exchange rate seems to be the most important policy, followed by low restrictions on trade, and deficit spending.

Box figure 7.7 The phasing of reform



Note: Darker shading indicates intensive action. QRs, quantitative restrictions.

Box figure 7.7 illustrates the World Bank's definition of economic policy reform and its phases. Reform may require up to ten years to implement successfully. Areas of reform include macroeconomic measures to fight inflation, maintaining positive interest rates, liberalizing prices by ending subsidies, removing trade restrictions and reducing tariffs, liberalizing banks and developing stock markets, privatizing state-owned enterprises, attracting foreign investment, establishing property rights, reforming the legal and regulatory framework, and establishing a social safety net to protect the poor and unemployed.

OVERVIEW OF ECONOMIC REFORM IN U.S. AID PROGRAMS

Before describing in detail the complex shifts in Presidential foreign aid strategy about economic reform, this section presents an overview of the main issue. From 1948 to 1962, there were ten different directors of the main American aid agency in just fourteen years.[9] The agency was re-named and re-organized. The Congressional mandate for foreign aid was changed as well. The Economic Cooperation Administration of the Marshall Plan was replaced in 1951 by the Mutual Security Agency, which included the former Point Four program -- renamed the Technical Cooperation Administration -- which remained in the State Department. These aid operations were absorbed in 1952 by the Foreign Operations Administration, which was replaced in 1956 by the International Cooperation Administration, (ICA).

In 1957, a Senate Special Committee to Study the Foreign Aid Program sponsored a series of research efforts. The most important was an MIT study that recommended long-term aid commitments based on objective economic criteria, rather than the approach of short-term aid for tactical foreign policy purposes. In 1957, Congress appropriated $300 million for this purpose in a new Development Loan Fund (DLF). In the first year of the Kennedy administration, this DLF and the ICA were combined into a new Agency, A.I.D.[10]

[9] There is no complete, scholarly history of A.I.D. or the U.S. foreign aid program, in spite of hundreds of books about the general subject of foreign aid and economic development. Background material used in this section is drawn from Joseph Marion Jones, The Fifteen Weeks: February 21-June 5, 1947. New York: Harcourt, Brace and World, 1955; Arthur M. Schlesinger, Jr., A Thousand Days: John F. Kennedy in the White House, Boston: Houghton Mifflin, 1965; Theodore C. Sorenson, Kennedy, New York: Bantam, 1966; Robert A. Packenham, Liberal America and the Third World, Princeton: Princeton University Press, 1973; Philip Geyelin, Lyndon B. Johnson and the World, New York: Praeger, 1966; Frank M. Coffin, Witness for Aid, Boston: Houghton Mifflin, 1964; Willard Thorp, "Foreign Aid: A Report on the Reports," Foreign Affairs, April 1970.

[10] Legislative Reference Service, Library of Congress, U.S. Foreign Aid: Its Purposes, Scope, Administration, and Related Information, Washington, D.C., Government Printing Office, 1959, pp. 11-12.

A new "Foreign Assistance Act of 1961" replaced previous foreign aid legislative goals. This Act (A.I.D.'s Congressional mandate) emphasized "self-help," which was the name for "economic policy reform" at the time. Self help was also the focus of new Alliance for Progress for Latin America. As will be discussed, President Kennedy was very proud of these achievements, considering the Alliance "the most important element of his Administration's foreign policy."[11] By 1967, however, aid levels had declined and the Senate Foreign Relations Committee even repealed the entire section of the law about A.I.D.'s goals to express anger at President Lyndon Johnson's Vietnam policy which greatly expanded the size of A.I.D. as part of the war effort.

Prior to the Kennedy Administration's focus on "self-help," it is difficult to pinpoint when economic policy reform became an explicit goal of U.S. foreign aid. In 1947, the first American foreign assistance program was to Greece and Turkey. It did not have the explicit goal of reforming the economic policies of aid recipients.[12] Nor did the programs of the IMF or the World Bank, which made its first loans to three developing nations (Chile, Mexico and Brazil) in 1948-49 without the kind of conditions for economic reform that later became a common part of loan agreements in the 1970s.[13] However, non-economic conditions were placed on both American aid and on loans by the World Bank, such as its first loan to France in 1946 that was held up to be sure Communist deputies would be excluded from a coalition

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[11] New York Times, March 12, 1962; Arthur M. Schlesinger, Jr., A Thousand Days: John F. Kennedy in the White House. Boston: Houghton Mifflin, 1965, pp. 546-548; Theodore C. Sorenson, Kennedy. New York: Bantam, 1966, pp. 530-534; Louise Fitzsimons, The Kennedy Doctrine, New York: Random House, 1972, pp. 89-90.

[12] Irma Adelman and Hollis B. Chenery, "Foreign Aid and Economic Development: The Case of Greece," Review of Economics and Statistics, February 1966; William Hardy McNeill, Greece: American Aid in Action, 1947-1956, New York: Twentieth Century Fund, 1957.

[13] The origins of economic reform operations at the World Bank and IMF are described below in the discussion of the Kennedy administration. In 1964, the World Bank hired Irving S. Friedman from the IMF to set up a general economics office for country research and to establish a program of country economic analysis similar to what he had initiated at the IMF in the 1950s.

government.[14]

In 1947, economists believed that poor nations needed two things to grow wealthy --1) capital to supplement their low investment due to low savings rates, and 2) knowhow such as scientific knowledge, education, and technology. This narrow view of the causes of economic growth tended to direct attention away from examining the economic policies of the poor nations. It helps explain why the main aid proposals debated in the Truman and Eisenhower Administrations centered around two questions -- 1) How much foreign aid is enough? and 2) Which nations should receive aid?

One school in the debate, with President Eisenhower's support, stressed the severe budgetary constraints on foreign aid, which could be afforded mainly to hold back Communism. President Eisenhower's main aid initiative came in his second term in 1957 when he proposed (and Congress approved) a Development Loan Fund. Earlier, Eisenhower had re-assigned Harold Stassen, his activist chief of the foreign aid agency, because he pressed too zealously for aid increases and a "world economic plan."

A second school centered around Senator John Kennedy, who was appointed to the Senate Foreign Relations Committee in 1957. With the help of the Senate majority leader Lyndon Johnson, Kennedy was moved ahead of the more senior Estes Kefauver. Kennedy's main legislative initiative in 1957-58 was a Senate resolution (co-sponsored with Republican Senator John Sherman Cooper) and a series of Senate floor speeches stressing the strategic importance of aiding the developing nations, especially India. Kennedy also mentioned the need to follow the advice of two MIT economics professors, Walt Rostow and Max Millikan, to provide assurances of long-term foreign aid mainly to nations chosen for their "absorptive capacity" according to economic criteria.[15]

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[14] Walter Isaacson, The Wise Men: Six Friends and the World They Made: Acheson, Bohlen, Harriman, Kennan, Lovett, McCloy, New York: Simon and Schuster, 1986, p. 429.

[15] W.W. Rostow, Eisenhower, Kennedy and Foreign Aid, University of Texas Press, 1985, pp. 152-162; Russell Edgerton, Sub-Cabinet Politics and Policy Commitment: The Birth of the Development Loan Fund, Syracuse: Inter-University Case Program, 1970, pp. 77-80.

Kennedy's interest in foreign aid developed in 1951 when he and his brother Robert visited Israel, Pakistan, India, Indochina, Malaya, and Korea. After that trip, Kennedy reversed his opposition to aid. He had initially voted against Point Four as a Congressman. Now he began to emphasize the value of foreign aid in a series of Senate speeches, an article in Foreign Affairs in October 1957, most of which criticized the inadequacy of President Eisenhower's policy toward the developing nations; and a book entitled The Strategy of Peace in 1960 in which eight of ten "areas of trial" were about the developing world.

There was one important voice of dissent against Kennedy's Senate resolution and his praise for Walt Rostow's theory that foreign aid (to properly selected nations with absorptive capacity) would generate a "take-off" in savings rates and therefore cause "self-sustaining" economic growth so that foreign aid could be terminated. The dissenting voice was P. T. Bauer, a Hungarian-born British professor at the London School of Economics who wrote a short book urging rejection of Senator Kennedy's (and Senator Cooper's) resolution on the need for more aid for India.[16]

According to Bauer, India (and other developing nations) were following foolish economic policies by trying to control the market, invest in heavy industry and downplay the role of the private sector. Aid would only reward these anti-growth policies. Rostow in effect accepted Bauer's point by claiming that it was already subsumed in Rostow's broad concept that aid must be provided only to nations with sufficient "absorptive capacity." However, Bauer and Rostow did not agree on what constituted adequate absorptive capacity. Significantly, however, Rostow (and later the leadership of A.I.D. appointed by President Kennedy) accepted Bauer's profound emphasis that American foreign aid should be allocated with an eye to the quality of economic policy of the recipient government. In retrospect, Bauer and Rostow both insisted that the receiving country must have an over-all development program designed to make the most effective possible use of its resources. These two economists did not advocate aid for what later was called "Basic Human Needs."

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[16] P.T. Bauer, United States Aid and Indian Economic Development, Washington, D.C. : American Enterprise Association, November 1959.

Rostow was more forgiving than Bauer of India's economic policy.[17] Bauer's book criticizing Senator Kennedy's resolution proposed an alternative that may have been the conceptual "invention" of A.I.D.'s role in policy reform. Bauer wrote:

> One approach would be a policy under which American aid would be varied in accordance with the overall economic policy pursued by the Indian government over the previous period. The amount of aid could then be made to depend on the performance of the Government ....[18]

Senator Kennedy and Professor Rostow seemed to want to aid nations with the proper absorptive capacity but then leave them alone, while Bauer was proposing that even after aid began, the nation should still be monitored by the aid donor who would then adjust further aid according to its performance. The difference would become important in later years when few poor nations maintained good economic policies.

Prior to the appearance of Bauer's book, Senator Kennedy had written:

> The United States is economically capable of increasing aid for development purposes, but it cannot scatter its assistance on each parched patch of misery and need. The first step would seem to be to make a small number of investments through aid and loans, selected with an eye to their likelihood for success. There is no need for us to be neutral as to the objectives which it should serve. Successful foreign aid must be selective. . . .[19]

A combination of Bauer's alternative and the Kennedy-Rostow approach was to become the hallmark of A.I.D. policy in many nations, especially after President Kennedy became dissatisfied with and replaced his first two Administrators and finally appointed David Bell, an economist he admired for his service as head of his budget bureau in 1961, to head A.I.D as its third Administrator. David Bell had served in Pakistan with the Harvard Development Advisory Service. By heading A.I.D. four years, Bell ended the disruptions caused by the rapid succession of ten different aid agency administrators from 1949 to 1962. P.T. Bauer (with Professor Rostow and Senator Kennedy) may have fathered the concept of

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[17] Later, however as President Johnson's national security adviser, Rostow saw enormous pressure put on India to modify its development strategy. This is a case study in this report.

[18] Ibid., pp. 103-106.

[19] John F. Kennedy, "A Democrat Looks at Foreign Policy," Foreign Affairs, October 1957, pp. 53-54.

an American role in promoting economic policy reform, which went beyond the Marshall Plan reviews of economic policies, but it was A.I.D.'s David Bell who began to make it happen.[20] Four of the success stories to be examined (Taiwan, Korea, India and Indonesia) occurred in large part while Bell headed A.I.D. from 1962 to 1966.[21]

ECONOMIC POLICY REFORM IN THE TRUMAN ADMINISTRATION

President Harry Truman is usually credited with initiating American foreign aid. He initiated both the Marshall Plan for Europe announced in 1947, the aid to Greece and Turkey mentioned earlier, and the Point Four plan announced two years later in 1949. Neither of these foreign aid programs focussed on economic policies of the recipients of aid. Nor did Lend Lease, an earlier aid program during World War II that provided to forty nations billions of dollars of non-military aid under Congressional authority. Lend Lease, like the Marshall Plan and Point Four, was not tied to any explicit economic policy conditions. However, the Marshall Plan was based on U.S. acceptance of each recipients overall recovery plans. [22]

As noted earlier, in 1947, two years after Lend-Lease ended but before the Marshall Plan and Point Four, the first formal American economic aid program was designed to aid only Greece and Turkey. It lacked an explicit requirement for economic policy reform, in spite of the flawed policies then being pursued by Athens and Ankara. The program originated quickly during the "fifteen weeks" (the title of a book about the period by President Truman's speechwriter) after the British government informed the United States in late

[20] Bell's Office of Program Coordination in 1965 issued the first comprehensive review of lessons learned from experience in economic policy reform. It covered not only the Eisenhower experience, but A.I.D.'s experience in the 1960s in Chile, Colombia, Brazil, Pakistan, and Taiwan. The paper was also presented to the OECD Development Assistance Committee in Paris. See Clarence S. Gulick and Joan M. Nelson, Promoting Effective Development Policies: A.I.D. experience in the Developing Countries, A.I.D. Discussion Paper No. 9, September 1965, PN-AAK-063.

[21] David Bell, "The Quality of Aid," Foreign Affairs, July 1966.

[22] Legislative Reference Service, Library of Congress, U.S. Foreign Aid: Its Purposes, Scope, Administration, and Related Information, Washington, D.C.: Government Printing Office, 1959.

February 1947 that it could no longer continue aiding the governments of Greece and Turkey. American economic aid for Greece and Turkey was not explicitly conditioned on those nations adopting any economic reforms. In fact, they were obligated only to "work out their destinies in their own way" with an eye to a goal of "economic stability," according to President Truman's proposal on March 12, 1947 when he asked a joint session of the House and Senate to appropriate $400 million for economic, technical and military assistance for Greece and Turkey. [23]

Truman knew he was founding an American foreign aid effort with long-term implications when he told Congress:

> I am fully aware of the broad implications involved . . . I believe that we must assist free peoples to work out their destinies in their own way. I believe that our help should be primarily through economic and financial aid which is essential to economic stability and orderly political processes.[24]

The Truman administration was aware of the need for reform in Greece and Turkey, but chose to overlook the issue. A former chief economist of the World Bank has noted that this American aid was not used to reform Turkey's mistaken economic policy.[25] Nor in Greece were any economic reforms demanded as pre-conditions by the United States, according to Truman's speechwriter who wrote later that this economic aid for Greece had to be provided in spite of the fact that the Greek government was "corrupt, reactionary, inefficient, and indulged in extremist practices."[26]

Without any conditions, Congress appropriated $300 million for aid to Greece and $100 million for Turkey. The pace of economic reforms would be slow but reforms did come

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[23]Joseph Marion Jones, The Fifteen Weeks: February 21-June 5, 1947, New York: Harcourt, Brace and World, 1955, p. 186.

[24]Public Papers of the Presidents of the United States, Harry S. Truman, 1947, Washington, D.C.: Government Printing Office, 1960, p. 179.

[25] Anne O. Krueger, Foreign Trade Regimes and Economic Development, Vol. 1: Turkey, New York: Columbia University Press, 1976. Krueger states that Turkish officials disregarded A.I.D. warnings until they ran out of foreign exchange in 1958.

[26] Jones, The Fifteen Weeks, p.185.

eventually. In Turkey, American advice on economic reforms was accepted, but not until the 1980s, thirty years later.[27] Greece too was slow to reform By 1966, more than fifteen years later after Truman's efforts, Greece was praised by an assistant administrator at A.I.D. (and also later Chief Economist of the World Bank) as one of the best three successes of American foreign aid, along with Taiwan and Korea.[28]

Although U.S. aid was not conditioned upon the recipients adopting economic policy reforms, there were economists involved in the foreign aid program as soon as a foreign aid agency was established. Toward the end of the "fifteen weeks" in 1947, President Truman greatly enlarged the geographic scope of American economic assistance beyond Greece and Turkey to include the rest of Europe. This required a large staff. Nine months after the Marshall Plan was announced on June 5, 1947, Congress enacted an "Economic Recovery Administration," one of the predecessors of the Agency for International Development. Professional economists played important roles in the new agency. These economists regularly reviewed the economic plans and policies proposed by European governments as a condition of providing aid funds. After review, the funds were then allocated to the Organization for European Economic Cooperation (OEEC, later the OECD) to be re-allocated to the 16 member nations according to the plans that they had submitted for American approval.

The concept of reviewing the economic policy of the recipient government prior to allocating American foreign aid was thus born in the Economic Recovery Administration offices. Written agreements were made about how the American aid funds would be spent. Obviously, however, European governments had extensive economic expertise themselves. There was no conflict about economic reforms between the American economists and their European counterparts. The shared goal was restoration from wartime devastation rather than

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[27] Anne O. Krueger, Economic Policies at Cross-Purposes. The United States and the Developing Countries, Washington, D.C.: The Brookings Institution, 1993, pp. 52-53.

[28] Hollis B. Chenery and Alan M. Strout, "Foreign Assistance and Economic Development," American Economic Review, September, 1966, pp. 679-733.

reform or economic institution building.[29]

Just as the aid program for Greece and Turkey had been expanded under the Marshall Plan to the rest of Europe, so the structure and style of the Marshall Plan's Economic Cooperation Administration (ECA) was soon expanded to the developing nations. Congress first extended the geographical mandate of this agency to China in its original enactment of the Marshall Plan in 1948. When the funds for China could not be spent, Congress agreed to the ECA request that its scope should be expanded to "the area around China" which in 1948 included Burma, French Indochina, Thailand, and the Philippines. The geographical scope of U.S. aid was expanded in June 1949 to Korea when President Truman relieved the U.S. Army of its aid duties in Korea and announced instead that, "Full advantage should be taken of the broad and successful experience in Western Europe by continuing responsibility for the administration of the Korean aid program in the Economic Cooperation Administration."[30] In Asia too the ECA reviewed economic polices of the recipient countries and made its main focus their economic growth.[31]

Point Four, President Truman's third step in creating a foreign aid program for the U.S., was a step backward for economic policy reform because its main premise was that economic growth in the developing areas would come from providing technical "knowhow" rather than correct economic policy. Among the points in his inaugural address in 1949, the fourth one (Point Four) called for "a bold new program for making the benefits of our scientific advances and industrial progress available for the improvement and growth of underdeveloped areas."[32] Congress was now asked to authorize a worldwide expansion of

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[29]Harry Bayard Price, The Marshall Plan and Its Meaning, Cornell University Press, 1955, *passim*.

[30]Public Papers of the Presidents of the United States, Harry S. Truman, 1949, Washington, D.C.: Government Printing Office, 1964, p. 279.

[31]Charles Wolf, Jr., Foreign Aid: Theory and Practice in South Asia, Princeton, N.J.: Princeton University Press, 1960.

[32]Public Papers of the Presidents of the United States, Harry S. Truman, 1949, Washington, D.C.: Government Printing Office, 1964, p. 547.

technical advisory "missions," the forerunners of A.I.D.'s extensive presence overseas.[33]

Congress did not question the premise of Point Four that economic growth would come from transferring scientific and technical advice without regard to the economic policies of the recipient nations. In spite of its bold and perhaps expensive goal of economic development for the underdeveloped areas, Congress quickly enacted the "Act for International Development" in part because a year of advance preparation and consultation with Congress had gone into the Point Four proposal, which apparently stressed that only a few years would be needed and not much American aid. Congress clearly knew the goal: Dean Acheson told the Senate Foreign Relations Committee that the Act established "economic development of underdeveloped areas for the first time as a national policy."[34] The Administration asked for $45 million, but just $35 million was appropriated for the newly created Technical Cooperation Administration, which was to operate in the developing world according to a geographic division of labor with the Marshall Plan's Economic Cooperation Administration. For the next decade, technical assistance appropriations rose to about $150 million a year, in contrast to the much larger $17 billion total requested budget for the Marshall Plan from 1948-1952, not all of which was spent.

The broad goal of the "Act for International Development" was clear enough. It was to assist the underdeveloped areas, with the hope that their prosperity would be good for world peace, for democracy, and for creating a new market for American exports. According to President Truman, the means of bringing about rapid economic growth in the underdeveloped world was entirely the provision of "knowhow." His public statements did not mention any need to inspect or reform the economic policies of the recipient governments. For example, in a speech to a group of civil engineers President Truman said if the United States were to "make a contribution in the knowhow, and raise the standard of living just 2 percent of the

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[33] A.I.D.'s In-County Presence, An Assessment, Center for Development Information and Evaluation, A.I.D., Washington, D.C., October 1992, PN-AAX-260, p. 5.

[34] Committee on Foreign Relations, U.S. Senate, Hearings, March 30 and April 3, 1950, p. 5. Reprinted in David A. Baldwin, ed., Foreign Aid and American Foreign Policy: A Documentary Analysis, New York: Praeger, 1966. pp. 60-66.

rest of the world, our factories and our businesses never could catch up with the demand that would be on them. Just think of that! That's all we need to do."[35] Significantly, studies in the 1950s of American Point Four "technical assistance" do not include economic policy reform as an issue within their purview.

Unfortunately, Point Four did not bring the expected dramatic improvement in the underdeveloped areas, probably in part because widespread and mistaken economic policies were not improved.[36] After five years of Point Four, the Congress became skeptical. In 1956, a House Committee report stated, "the blunt fact of the matter appears to be that most technical cooperation programs are conducted on a basis such that starting from an unknown point for an unknown goal they can tell neither how far they have progressed nor when they have got there."[37]

THE EISENHOWER ADMINISTRATION

One early approach the Eisenhower administration used to deal with the slow growth of the developing nations was simply to increase the level of aid. By the mid 1950s, after the success of the Marshall Plan, funds were available to divert to the underdeveloped areas because the Marshall Plan cost $4 billion less than the $17 billion Congress had originally

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[35] Public Papers of the Presidents of the United States, Harry S. Truman, 1949, Washington, D.C.: Government Printing Office, 1964, p. 547. President Truman may have been aware of a forthcoming UN estimate published in 1951 claiming two percent per capita growth could be achieved by the entire developing world with capital of $20 billion, according to a ICOR, an "Incremental Capital Output Ratio" model used in UN Group of Experts, Measures for the Economic Development of Underdeveloped Countries, New York: United Nations, 1951

[36] Initial justifications to Congress for Point Four and technical assistance implied that the program would only be needed a few years, just as the Marshall Plan had lasted only four years. There is no authoritative history of Point Four. Even the details of its origins were called "murky" by one of its administrators. See J. Bernstein, "Point Four and After," in Technical Assistance and Development, Jerusalem: Harry S. Truman Research Institute, 1970, p. 25. See Philip Glick, The Administration of Technical Assistance: Growth in the Americas, University of Chicago Press, 1957.

[37] "U.S. Technical Assistance in Latin America," House Committee on Government Operations, House Report No. 1985, March 290, 1956, p. 13.

appropriated. Under Truman, from 1949 to 1952, economic assistance averaged $3.4 billion a year, of which 86 per cent went to Europe. Under Eisenhower, in 1953-1957, the average annual average for aid dropped to $1.8 billion, but only 25 percent went to Europe. In 1958-61, the annual average was $1.85 billion, with only 6 percent for Europe. In addition, the Point Four technical assistance "missions" were funded at about $130 million annually.[38]

During the Eisenhower administration, a major new emphasis on economic policy reform was triggered by **Congressional requests for studies of the future of foreign aid. Senator John Kennedy was active in this effort as one of eight Senators who signed a letter requesting a re-evaluation of foreign aid. In 1957, a Senate Select Committee to Study the Foreign Aid Program was set up.** As noted earlier, the most influential report for this Senate Committee was written and given widespread circulation in 1957 by two of Senator Kennedy's constituents who were in direct contact with him, Professors Max Millikan and W.W. Rostow of MIT. They advocated that **economic aid should be allocated to free world countries according to the strictly economic criterion of the level of capacity the country had to "absorb" capital effectively for economic growth.** This was a new concept because its separated developing nations according to their economic polices rather than their levels of poverty or needs. **Allocating aid according to economic criteria undermined the argument behind Point Four that scientific knowhow would spur economic growth.** If economic capacity to absorb was the crucial criterion, then Congress should focus attention on the nature of each recipient government's policies and capacity for economic growth. **The need for economic policy reforms had not been addressed by Congress in its extensive hearings and floor debate about the Marshall Plan or Point Four.**

Something of a new era began when Rostow and Millikan suggested in 1957:

> **The essential idea of our program is that the allocation of funds should be based on a banking concept rather than a subsidy concept.** A banker does not list all his potential customers and then try to decide how to allocate his loanable funds in such a way as to be fair to each. . . . Indeed, our central idea--that funds be allocated according to a banking concept of credit worthiness and technical absorptive capacity--hinges on the possibility of **establishing**

[38] Under the Kennedy and Johnson administrations, from 1962-66, the annual aid total increased to $2.3 billion which all went to developing nations.

> criteria sufficiently objective that experts could readily determine whether a given application of resources was likely to justify itself in terms of increased productivity.[39]

The Senate pressed President Eisenhower both to re-focus aid on nations with the most "absorptive capacity" and to increase aid levels overall with long-term commitments. In 1959, Senator Kennedy declared in a Senate speech that in addition to the "missile gap" he had uncovered (with the help of Senator Lyndon Johnson and their Senate subcommittee staff aide Cyrus Vance), the Eisenhower administration had allowed "an equally clear and present danger to our security:

> The economic gap--the gap between the developed and underdeveloped worlds . . . It is this gap which presents us with our most critical challenge today. . . . And it is this economic challenge to which we have responded most sporadically, most timidly and most inadequately.[40]

President Eisenhower did not attempt to change the approach of the foreign aid program in accordance with this proposal. However, his proposal for a U.S. Development Loan Fund, already several years in the making, was consistent with Rostow's idea and was quickly approved by Congress in 1959. Thus, the full implementation of the new concept to link aid to economic performance occurred only when the young Senator who had praised Rostow became President and appointed him head the Policy Planning Council of the State Department. As mentioned, four of the A.I.D. case studies in this report (Taiwan, Korea, India and Indonesia) occurred while Rostow worked in the Kennedy Administration or when he was President Lyndon Johnson's National Security Adviser.

To be sure, all economic policy reform did not begin in the Kennedy administration. Academic economists had been publicly and privately advising developing nations. At the

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[39] Max F. Millikan and W.W. Rostow, A Proposal: Key to An Effective Foreign Policy, New York: Harper, 1957, p. x.

[40] The Congressional Record, 86th Congress, First Session, Vol. 102, Part 2, pp. 2737-2740. Senator Kennedy's speech also emphasized India's aid needs, based on Barbara Ward's widely-read, twenty-page special report on India in the January 22, 1955 Economist. Barbara Ward's role in persuading Robert McNamara to change World Bank policy in 1970 is discussed below.

IMF, in spite of Lord Keynes wishes against it at the Bretton Woods conference that set up the IMF and World Bank, the IMF began to set conditions for reform on IMF loans in the 1950s. Neither the IMF nor the Bank could dictate economic policies to borrowing countries, but they could make policy reforms a precondition for lending. In 1964, the World Bank hired away the chief IMF economist to create its own staff to consider conditions on loans, but this was three years after A.I.D. was already doing so with its development loans and the "policy dialogue" carried out by large resident staffs in the missions that A.I.D. maintained overseas.[41] In isolated cases, U.S. aid had sometimes been suspended or linked to various conditions. Rostow himself has acknowledged that, "as the Eisenhower administration came to a close, World Bank consortia for India and Pakistan were emerging, a soft loan window of the World Bank existed, the IDB (Inter-American Development Bank) had been created, and the DLF was expanding its operations as part of the U.S. aid program."[42] What was new was the

[41] Irving S. Friedman, "Private Bank Conditionality: Comparison with the IMF and the World Bank," in IMF Conditionality, edited by John Williamson, Cambridge, Mass: MIT Press, 1983, pp.113-116. Friedman writes, "The question of whether access to the financial resources of the IMF should be automatic or managed (conditional) has been with us since the deliberations that preceded the Bretton Woods conference. My responsibilities within the Fund, and then in the World Bank, gave me the opportunity to play a leading role in this area of management in these institutions for nearly 25 years. A few remarks on these institutions may be helpful . . . . It was resolved in the early 1950s (in the IMF), but only after about five years experience that nearly paralyzed the Fund as a financing institution . . . . From the beginning, I advocated conditionality, but believed that the content of conditionality had to be different for differing countries and changed over time as countries and the world economy changed. When I went to the World Bank in 1964 to create a general economic staff and a program of country work, I brought with me a bias in favor of conditionality. . . . Much of what the Fund did was not provided for in the Articles. Our program of periodic country visits, reports, recommendations, and Board deliberations on countries, which I had the opportunity to initiate and manage, were not provided for in the articles. . . . Long before Fund financing became of some importance, the Fund delved into domestic conditions and polices. . . . It came to live at the center of domestic policymaking. We began to put these country concerns on a systematic basis in 1964-65 at the initiative of George Woods and this work was carried forward by Robert McNamara. It was the main reason that I was asked to come from the Fund to the Bank in 1964. We created a staff for this purpose. . . ."

[42] W.W. Rostow, Eisenhower, Kennedy and Foreign Aid, Austin: University of Texas Press, 1985, p. 203. On pp. 204-207, Rostow concludes also that "The arrival at the White House of John Kennedy with his whole-hearted and deeply rooted acceptance of the doctrines

explicit strategy that a fundamental goal of foreign aid should be to allocate it according to policy.

Rostow credits himself and Senator Kennedy for some of this progress, but twenty years after these events, Rostow wrote:

> Looking back at the intellectual struggle for development aid of the 1950s, I would underline a chastening fact. The path-breaking victories. . . did not come because, at last, we persuaded the opposition that we were right. They came about because a series of crises emerged in the developing regions. . . . It was Vice President Nixon's difficulties in Lima and Caracas in May 1958 that shifted the balance of power within the Eisenhower administration towards support for the IDB and other positive responses to Latin American development needs. . . . In fact, the whole critical period when the long-run foundations for development assistance were laid was framed by the protracted anxieties. . .that followed the Soviet launching of the first satellite in October 1957. . . . Nevertheless, the work of the development crusaders was not irrelevant.[43]

THE KENNEDY ADMINISTRATION

On March 22, 1961 in his first message to Congress about foreign aid, President Kennedy criticized existing aid concepts as "largely unsatisfactory" for the future, proclaimed the concept of a Development Decade, and launched the Alliance for Progress. He not only put forward Professor Rostow's concept of economic growth, but he also persuaded Congress to nearly double foreign aid his first year in office. The annual aid average of $2.5 billion between 1956 and 1960 rose to an average of $4 billion between 1961 and 1963. Perhaps

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of the development crusaders of the 1950s, did not launch a long era of expanded development assistance and amicable North-South relations. . . . The major achievement of the 1960s--and Kennedy's in particular--was to institutionalize a substantially larger share of development aid around serious, internationally recognized criteria . . . ."

[43] Ibid., p. 203. Vice President Nixon was roughed up by mobs in Lima, Peru and Caracas, Venezuela, so that President Eisenhower alerted U.S. forces that Nixon might have to be rescued by force. Ironically, Kennedy and Nixon were had been "friends" as freshmen Congressmen, with offices near to each other, and Nixon's stoning in Peru and Venezuela in 1958 has been described as affecting then Senator Kennedy's decision to focus on what three years later became the Alliance for Progress. See Arthur M. Schlesinger, Jr., A Thousand Days, pp. 191-194.

more important than raising the total aid levels, the Kennedy Administration doubled the proportion of development aid to military aid, from one-third to two-thirds of total aid.

President Kennedy created A.I.D., which absorbed the functions of the Development Loan Fund and the International Cooperation Administration. Professor Rostow and others from the "Charles River Group," according to Arthur Schlesinger, Jr., installed country programming to replace the traditional scattered individual aid projects. Efforts were made to develop quantitative economic criteria for assistance. Great stress was placed on defining "self-help."[44] A.I.D. established individual "country programming" to be done in four regional bureaus headed by Assistant Administrators with the same high rank as Assistant Secretaries of State. Congress quickly enacted the "Foreign Assistance Act of 1961" with extensive new goals for foreign aid.

We can see the strengthening of economic policy reform of the Kennedy Administration most clearly in two important documents from 1961. The first was a section defining "self help" in the Report of the Task Force on Foreign Aid. This section on "self-help" was reprinted in the A.I.D. congressional briefing. Under the title "What Does Self Help Mean?" A.I.D. defined the requirements of economic policy reform that many observers later mistakenly believed were invented in the 1980s by the World Bank in its first structural adjustment loans or by the Reagan administration in its "Four Pillars" policy at A.I.D.

To demonstrate how similar current usage is to A.I.D.'s 1961 definition of its role in promoting economic reform, the six main points from the documents of 1961 are listed below. Each of the six points is illustrated by quotations from the text of the Task Force Report to the President and the annex of A.I.D. 's Congressional presentation:

1) EXPORT DIVERSIFICATION AND PROMOTION: "The problem of supporting internal growth by means of external trade is a critical one for underdeveloped countries. . . The world will simply not absorb a very much larger volume of the traditional exports which underdeveloped countries already produce." Therefore, A.I.D. recommends that "diversification into new industries is usually the key both to export expansion and the reduction of import requirements. . . .This venture into diversification will have its own

[44]Arthur M. Schlesinger, Jr., A Thousand Days, pp. 586-589.

burden. . . . The country's endowment in natural and human resources, its readiness for new technique and innovation, and the size of its domestic markets will help determine which industries should be undertaken first."

2) REALISTIC EXCHANGE RATES: "Persistent balance of payments problems can usually be relieved by adjusting the exchange rate and controlling inflation. Unrealistic exchange rates usually have three costly consequences: exports are neglected; imports are underpriced; and favoritism flourishes because private traders receive windfall gains."

3) REFORM OF PUBLIC ENTERPRISES: "Large public sector investments. . .clearly cannot provide the same kind of help for sustained developments as private investors who generate government revenue or private savings. . . . Public enterprise should repay the capital it uses at the business rate of interest rather than the subsidized rate on government loans. It is also indispensable that public corporations should set up proper accounting procedures and publish current reports which show their costs and earnings in a form that can be understood."

4) ELIMINATING SUBSIDIES AND PRICE CONTROLS: Countries need to be given "clear and complete instruction on price policy. . . .There are many pitfalls in the way of providing savings which are adequate to sustain development without continued dependence on foreign assistance. One of the most common is the temptation for governments to control prices. Price control often suppresses profits and has a perverse effect on both revenue and business savings. . . .Underpricing of essential items, such as coal, steel and electric power, either by public enterprise or by price controls, leads to the misuse of resources."

5) TAX REFORM: "In poor countries, the income tax rarely yields enough revenue. Consequently, excise taxes are often a useful means of restraining consumption and achieving a more productive use of limited capital."

6) PRIVATE SECTOR INITIATIVE: "Underdeveloped countries need a great many things besides capital. These include all the things which cause change to spread throughout the economy. More foreign aid, by itself, does not suffice. It can be counter-productive. . . . This requires entrepreneurs, savings, skilled workers and, above all, government polices which foster savings, innovation and enterprise."

President Kennedy placed some limits on economic reforms. The 1961 Congressional presentation concludes that, "The standards set for development criteria will thus have a range of variation." The annex explains to Congress that there can be no "dogmatic approach" when "strategic objectives" are the goal of U.S. aid: "Where economic assistance is justified for short-run political or military reasons, the standards that can be set for self-help measures of an economic sort cannot be very high." A vivid example was Haiti, the poorest nation in the hemisphere. Although Haiti's economic policies were in extreme need of reform, the A.I.D. presentation to Congress explicitly ruled out any pressure on Haiti for self-help measures. Instead, U.S. aid was to be used only to keep President Duvalier from establishing friendly relations with Castro's Cuba, which was advocated by an influential group of young advisers to President Duvalier.

In spite of exceptions like Haiti, the overall level of commitment in the Kennedy Administration to economic policy reform was strong. An outstanding effort was attempted with respect to Latin America. In fact, the Charter of the Alliance for Progress actually specified what economic policies had to be covered in national development plans and established a committee of experts to carry out mandatory reviews of the economic policies in each national development plan.[45]

President Kennedy clearly committed himself to foreign aid and the Alliance, frequently stressing the role of reform in economic growth. As mentioned earlier, he considered the Alliance the most important element in his Administration's foreign policy. He spoke on the sites of four A.I.D./Alliance projects in December 1961 in Venezuela and Colombia, in March 1962 in Mexico City, and in March 1963 in Costa Rica, and he said at a March 14, 1962 news conference that the Alliance is "just as important as our national

[45] The strategy and accomplishments of the Alliance for Progress are beyond the scope of this paper. A very critical appraisal is Jerome Levinson and Juan de Onis, The Alliance That Lost its Way, Chicago: Quadrangle, 1970. Arthur Schlesinger, Jr. advised President Kennedy that the Alliance should be an independent agency, outside of A.I.D. and State Department. A memorandum to President Kennedy quoted a Deputy Assistant Secretary of State about the opposition of the Foreign Service to the Alliance, "They form a sullen knot of resistance to fresh approaches." Cited in Barbara Kellerman and Ryan J. Barilleaux, The President As Wold Leader, New York: St. Martin's Press, 1991, p. 92.

defense."[46]

EROSION OF KENNEDY'S STRATEGY: TRENDS AND DECISIONS

It is difficult to identify a precise date when A.I.D.'s role in economic reform began to diminish. Three trends were at work, and three key decisions made. The first decision was to redirect aid away from A.I.D. and channel it to a greater degree through multilateral lending institutions. This decision had its origins in the early 1960s as part of an effort to persuade Europe and Japan to pay their fair share of foreign aid which, for various reasons, had to be channeled through multilateral institutions. World Bank loans began a major expansion as its new president tapped new sources of capital in Japan and Germany.

The second decision was to reduce the role of A.I.D. in economic policy reform. It was apparently triggered in 1970 by the Peterson Commission report to President Nixon. In response to a request by Congress in 1969, Nixon appointed a study commission to be chaired by Bank of America President Rudolph Peterson. Among other things, the commission recommended that multilateral lending institutions replace A.I.D. in the work of economic policy reform, including performing macroeconomic analysis of developing nations.[47] It also recommended that A.I.D. return to its focus in the 1950s on project grants and lending. The leadership of A.I.D. in the Nixon Administration accepted this view and reduced its staff for analysis of overall economic frameworks, shifting emphasis back to project aid and technical assistance. A.I.D. personnel were increasingly experts not in economic reform, but in health, education, population and nutrition. This change was accelerated with the enactment of the New Directions, or "basic human needs" legislation in 1973 that set up so-called functional accounts in the A.I.D. annual budget for various types of projects. One result was that A.I.D. personnel, budget planning and program goals all centered around functional activities

[46] Kellerman and Barilleaux, op. cit., pp. 90-91.

[47] Task Force on International Development, U.S. Foreign Assistance in the 1970s: A New Approach: Report to the President, Washington, D.C.: Government Printing Office, 1970; Anne O.Krueger, Economic Policies at Cross-Purposes, The Brookings Institution, 1993, p. 40.

(education, population, nutrition, agriculture, etc.). **There was no budget account for economic reform. There was no office by that name. Most importantly, there were no requests from Congress for progress reports on economic policy reform.** Congress did ask for reports about functional accounts, either in written form or in testimony, which seemed to be what the U.S. foreign aid program was all about.

As a recent A.I.D. report phrased it, "Economists were out, anthropologists and sociologists were in."[48] A former Chief Economist at the World Bank concluded:

> When in the aftermath of the early 1980s debt crisis, worldwide attention centered on the overall economic policy framework of developing countries, U.S.A.I.D. was unable to play an effective role, having lost its capacities for macroeconomic analysis .By the early 1990s U.S.A.I.D. was continuing to provide significant proj. aid for low-income countries, but its presence was far less visible than before, as more and more economic policy toward developing countries was formulated and executed by the U.S. Trade Representative, the Treasury Department, the Agriculture Department, and other agencies.[49]

In 1970, a third decision downgraded economic reform within the World Bank, after the role of promoting reform had supposedly been transferred from A.I.D. to the Bank because the Bank could do it better. The Bank decided to re-orient its loans to emphasize direct poverty alleviation and meeting "basic human needs" of the poorest of the poor. The rise of the doctrine of "basic human needs" in the 1970s thus affected both A.I.D. and the Bank, and did more to set back efforts for economic reform than any other decision or trend. Its consequences will be examined below.

Behind these three decisions to rely on the multilateral banks for economic reform, to reduce A.I.D.'s role in promoting economic reform, and to emphasize basic human needs, there were basic trends at work. The first of the three trends was the reversal of the overall upward trend of U.S. aid that had begun under President Kennedy, then slowed when President Johnson declined to contest Congressional aid cuts. The second trend was the

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[48] A.I.D.'s In-County Presence, An Assessment, Center for Development Information and Evaluation, A.I.D., Washington, D.C., October 1992, PN-AAX-260, pp. 4-5.

[49] Ibid., pp. 41-42.

decline in the U.S. share of OECD development aid.[50] Under President Kennedy, the U.S. share of official development assistance had slightly increased from 58 percent in 1960 to 62 percent by 1963. By 1975, however, it had fallen by more than half to 26 percent. At the same time, the percentage of the American GNP contributed to official development aid dropped from 0.53 percent in 1960 to 0.32 percent in 1970.[51]

A third trend was indirectly weakened the capacity of A.I.D. to play an effective role in promoting economic reform. In 1964, only 6 percent of U.S. official development aid was contributed via multilateral institutions like the World Bank; but by 1970 the percentage more than doubled to reach 14 percent. By 1975, 35 percent of U.S. aid was contributed multilaterally. Although President Nixon's administration increased development aid by nearly 25 percent between fiscal year 1969 and 1971, most of the increase went to the multilateral lending institutions, not to the A.I.D. budget.

In addition to these trends, after President Kennedy, there were signs that economic reform no longer held the attention of the White House. President Johnson seldom mentioned the Alliance for Progress. American tolerance for backsliding on reforms in Latin America seemed to increase, not only about economic reform but also with respect to the overthrow of democratic leaders. Whereas President Kennedy had immediately suspended aid to Peru after a military coup there in 1961 (the U.S. Ambassador in Peru was the founder of Americans for Democratic Action.), President Johnson seemed more comfortable with what became known as the "Mann doctrine" that military coups would not be the occasion for suspending U.S. aid. President Johnson also gave A.I.D. new security-related duties (unrelated to economic reform) to support the U.S. troops sent to the Dominican Republic and the ever-growing American troop strength in South Vietnam.

Lyndon Johnson may have inadvertently triggered a major setback for economic policy reform by nominating his Defense Secretary Robert McNamara to be President of the World Bank, apparently to remove from his administration an opponent of continuing the

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[50] OECD members include Europe, Japan and the U.S.

[51] World Development Report, Washington, D.C.: World Bank, 1981, p. 164.

Vietnam War. McNamara was soon converted to the "basic human needs" or poverty alleviation approach.[52]

This change in the new head of the World Bank might not have affected the A.I.D.'s emphasis on economic reform except that three trends just mentioned greatly increased the importance of the World Bank (and the IMF and UNDP) in foreign aid. To sum up:

1) American aid was increasingly multilateral,

2) American aid was a much smaller portion of worldwide foreign aid, and

3) the multilateral agencies, especially the World Bank, now disbursed more foreign aid than A.I.D. and McNamara wanted to focus on direct aid to the poor.

Given these trends that strengthened the relative importance of multilateral lending, there was a major impact when the 1970 Peterson Report to President Nixon advocated transferring economic reform from A.I.D. to the World Bank. Such a transfer might have been effective if the World Bank President had not been about to adopt a view of indifference or hostility to the need for economic reform. The effort to transfer responsibility for economic reform to the multilateral lenders had not anticipated the conversion of Robert McNamara to

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[52] Deborah Shapley, Promise and Power: The Life and Times of Robert McNamara, Boston: Little Brown, 1993, pp. 437, 505. On pp. 507-509, Shapley writes,"The Board of Governors, even many in the Bank, wondered where McNamara's ideas were coming from, says Hollis Chenery, the Bank's leading economist after 1970. . . .This group in a sense launched the concept of development; its political philosophy reached back to the Fabian Society of Beatrice and Sydney Webb. The Fabians sought to use government as an equalizer of wealth in Great Britain. . . .In the 1960s in the United States, the best-known spokesperson for this critique of the aid establishment was. . . Barbara Ward, Lady Jackson. . . .While Chenery influenced him on technical issues, Ward convinced him that the Bank could direct resources at the bottom 40 percent--the largest number of the poor--and make them productive. She became a kind of beacon during the years when McNamara was a pariah at home and searching for an intellectual foundation for the Bank's program--a star to steer by. 'She influenced me more than anyone in my life,' he said of Ward later. . . .A turning point for McNamara came at a conference at Columbia University, in New York, in 1970 (also attended by the head of the IMF and the UNDP). . . . Some at the meeting wouldn't sit in the same room with him. After all, it was 1970. Massive student protests at Columbia in 1968 set the pattern for demonstrations taking place all around the country. . . .Also attending the Columbia was a Pakistani named Mahbub ul Haq, an intelligent and angry man. . . .aid was a tool of repression in Ul Haq's view. . . .Ul Haq came to enjoy much favor; the Bank staff worried that he was becoming 'a guru' to McNamara. . . ."

the need for direct aid to meet "basic human needs" rather than reform of economic policy. A.I.D.'s role was soon reduced to providing non-binding advice about development issues to the U.S. representatives to the World Bank (and IMF). However, A.I.D. could not even play this reduced role aggressively. A.I.D. not only lacked an explicit Congressional mandate to monitor economic reform, but also could only maintain a small multilateral affairs office that was unable to monitor whether economic reforms were sufficient in the five hundred or more loans a year made by the managers of the multi-billion dollar, multi-national World Bank.

ORIGINS OF THE "BASIC HUMAN NEEDS" APPROACH

There are several strands in the way economic policy reform was replaced by the basic human needs approach. At one level, the approach stemmed from a series of statistical studies that seemed to show the bottom fourth of the population in the developing nations were not being "reached" by aid even when national economic growth rates were improving. These studies were popularized by Barbara Ward, a persuasive British journalist and author, who personally "converted" McNamara. The ideas (and the phrase "basic needs") had originally been given prominence in 1969 in speeches by David Morse, the head of the International Labor Organization (ILO), the oldest UN specialized agency, and by Dudley Seers of the University of Sussex to an annual meeting of development experts, then by Mahbub ul Huq, a Pakistani economist hired by McNamara at the World Bank, who vividly attacked the emphasis on economic growth as follows:

> Where did the development process go astray? We conceived our task not as the eradication of poverty but as the pursuit of certain levels of average income. . . .The basic problem of development should be redefined as a selective attack on the worst forms of poverty. . . .We were taught to take care of GNP as this will take care of poverty. Let us reverse this and take care of poverty as this will take care of GNP.[53]

Ironically, the "basic human needs" approach was resisted by many developing nations for two reasons. First, it did not seem to justify larger aid flows from the wealthy nations

[53]Mahbub ul Haq, "Employment and Income Distribution in the 1970s: A New Perspective," Development Digest, October 1971, pp. 5-7.

needed for Rostow-style take offs into self sustaining growth. Second, and perhaps more important, the leaders of developing nations did not appreciate being told by Lyndon Johnson's ex-Defense Secretary to expand their welfare programs which they believed would have to come at the expense of overall national growth and perhaps national military strength.[54]

In spite of this resistance from the developing nations, Barbara Ward converted Robert McNamara to the approach in a series of meetings in 1969 and 1970, including the Columbia University conference. McNamara advocated direct aid to alleviate poverty in a way that rendered irrelevant the pressure to reform to attain growth through wise economic policy. According to McNamara, even quite high increases in national income, "have not reached the poor to any significant extent in most developing countries."[55] A study concluded in 1973 that "hundreds of millions of desperately poor people throughout the world have been hurt rather than helped by economic development."[56]

Several years later, a World Bank study and several others challenged these findings. But it was too late. By then the "basic human needs" approach had affected both the loan policy of the World Bank and the Congressional mandate of A.I.D. which was modified to add "Basic Human Needs" language in 1973. Hollis Chenery, formerly of A.I.D. and then Chief Economist at the World Bank, found his "basic human needs" research results subjected to devastating criticism. For example, a review of Chenery concluded "there is no evidence of large masses of people (like the lowest 60 percent or 40 percent or even 10 percent) suffering from growth in any country."[57] By 1982, a new statistical study concluded, "Where growth

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[54] H.W. Arndt, Economic Development, The History of an Idea, Chicago: University of Chicago Press, 1987, p. 110.

[55] Robert McNamara, Address to Board of Governors, World Bank, 1972, p.8.

[56] I. Adelman and C.T. Morris, Economic Growth and Social Equity in Developing Countries, Stanford, Calif.: Stanford University Press, 1973, p. 192.

[57] I.M.D. Little, Book Review, Journal of Development Economics, 1976, No. 3, p. 101.

was rapid all large sections of the population benefited, though some more than others."[58]

A Congressional Research Service study in 1988 concluded:

> While one of the basic assumptions behind the proposals of the New Directions policies in 1973 was the that the "conventional" development process had not worked for the majority of people in the LDCs, research done after the passage of the changes (in Congress) cast a different light on this issue. In Twenty Five Years of Economic Development, (World Bank, 1977) David Morawetz . . . demonstrated that there had been spectacular growth of (per capita) GNP in the LDCs from 1950 to 1975 (3.4 percent per year). This was faster than today's developed countries grew during their (historical) development, faster than the LDCs had ever grown before, and farther than anyone expected them to grow. . . (Among) Morawetz' most striking findings. . . .(were that) infant mortality rates dropped precipitously. Many diseases had been virtually eliminated; . . .primary school enrollments trebled and secondary and tertiary enrollments increased sixfold.[59]

There was a second strand to the origins of the human needs approach that also tended to undermine the legitimacy of economic policy reform as a foreign aid strategy. This factor may be based on the degree to which human compassion (rather than economics) is a more important psychological motive why the people of wealthy democratic nations provide foreign aid at all. Some would argue that for everyone (but professional economists) saving starving or sick children with direct aid always provides more of an emotional reward to donors than "merely" improving statistics about economic growth rates. Such an emotional payoff to donors can never compare to what happens when economic policy reform succeeds and the results on a human level are "merely" abstract, "intangible," and long-run. Such results may be appreciated only by those who understand the new statistics that arrive in government offices in the recipient countries and in foreign aid agencies. To some, such as professional economists, such statistical "results" may seem tangible because they can visualize what the statistics really will mean in improving the lives of millions of poor people. But for non-economists, reading statistics can hardly compare with seeing the truly tangible

[58] I.M.D. Little, Economic Development: Theory, Policy and International Relations, New York: Basic Books, 1982, p. 212. Emphasis added.

[59] Theodor W. Galdi, Development Assistance Policy: A Historical Overview; Congressional Research Service, Library of Congress, April 6, 1988, p. 15.

physical transformations that direct foreign aid to the poorest of the poor may bring, even if the transformation is of fewer people and will not be sustained. When a starving child becomes healthy, something different happens at the human level to the donor of the aid than happens to the economist reading statistics about improved growth rates in his air-conditioned office.

Besides the question of compassion for the desperately poor, "basic human needs" had an intellectual history. It was a rebellion against the purported inadequacy of the economic growth doctrines of the 1960s. More precisely, it was rooted in the "Columbia Declaration" of 1970, a document produced at a conference organized by Columbia University to review a World Bank report. McNamara himself addressed the Columbia conference and endorsed its themes. The participants aimed harsh criticism particularly at the Pearson Commission report of 1969, "Partners in Development," which was financed by the World Bank. The Commission had recommended an average annual GNP growth target of 6 percent for the developing countries. To achieve this, the report recommended that advanced nations double the percentage of GNP they were then spending for official development assistance to 0.7 percent of GNP with 20 percent to be allocated to multilateral agencies. Neither the Pearson Commission target nor the Columbia Declaration's higher target was ever met. For the next two decades, the average percentage of OECD development aid stayed around 0.34.

The importance of the "Columbia Declaration" came in another way. It directed attention away from overall growth rates in developing nations to the bottom quarter, the poorest of the poor. The message was that foreign aid had failed this group and should now focus on them within each nation and also on the poorest nations. This was a long way from Senator Kennedy's Foreign Affairs article, which had stated the U.S. "cannot scatter its assistance on each parched patch of misery and need." It was certainly out of tune with Professor Rostow's requirement that aid allocations "should be based on a banking concept rather than a subsidy concept." A pertinent passage of the "Columbia Declaration stated that "new objective criteria for effective development assistance are required. . . .It is essential to develop targets designed to achieve a minimum average per capita income of $400 to be reached by all countries not later than the end of the century. Criteria are also needed which focus on the living standards of the bottom quarter of each country's population."

In 1977, McNamara appointed an independent commission chaired by Willy Brandt which in 1980 published a report entitled "North-South." This report contained the "basic human needs" language and, like the Pearson Commission and the Columbia Declaration, it recommended a large increase in development aid. A final recommendation was that "A Summit of World Leaders" be convened "to change the international climate and enlarge the prospects for a global agreement" to increase aid. This report and the demand for a world summit on aid came after six years of negotiations and debate centered on the concept of a "New International Economic Order" featuring rhetorical demands that the wealthy imperialist world owed a debt to the poor nations. This debate, like the "basic human needs" approach, served to direct attention away from economic reform and toward the expected benefits of large increases in aid flows. However, after a series of international conferences and a special UN session in 1975, the debate faded. [60]A small increase in development aid occurred, but only an average of a few percent a year during the decade.

THE REAGAN ADMINISTRATION

By the time "A Summit of World Leaders" finally met in Cancun, Mexico in October 1981, President Ronald Reagan and his administration were ready to announce a new approach opposed to the demands of the New International Economic Order for large aid increases. President Reagan at Cancun stressed that the source of economic growth came largely through private enterprise rather than any governmental effort. Then he warned: "The rationale for aid to countries whose low economic performance results more from inappropriate domestic policies than from external factors needs to be re-examined." This warning was clearly something new: a threat to prohibit aid to nations which pursued "inappropriate domestic policies."[61]

[60]The World Bank cautiously recommends further study to determined what reduces poverty best: "It would be especially helpful to know whether social spending or overall growth in incomes was the more effective way to improve social welfare." World Development Report, 1991, World Bank, p. 47.

[61]Economic Report of the President, February 1982, Washington, D.C.: Government Printing Office, p.184.

Reagan's implicit warning went beyond the goal of the Kennedy administration to concentrate aid on nations where there was a likelihood of success. Reagan's warning was tougher even than P.T. Bauer's proposal that aid levels should depend on the performance of the recipient government. Here was a President apparently willing to rule out any aid to a nation unless it pursued appropriate policies. The Reagan administration soon completed a much-publicized re-examination of the World Bank and regional development banks which recommended, among other things, a shift from multilateral aid to bilateral aid and more pressure on developing nations to improve their domestic economic policies.[62]

In fact, the Reagan administration never followed up its warning. Instead, it emphasized the private sector in developing nations as a legitimate beneficiary of American aid. A change in the A.I.D. organizational structure added a private sector bureau. Direct aid to the private sector in poor nations without regard to the economic framework would have been a departure from the Kennedy approach. However, A.I.D. actually provided relatively little direct aid to the private sector. The focus tended to be to facilitate government policy reforms that would nurture private enterprise.[63]

Four key documents illustrate the overall policy of the Reagan administration toward economic policy reform. The first was issued by A.I.D. in 1982 as one of a series of thirteen "Policy Papers." "Approaches to the Policy Dialogue" was a classic re-statement of the Kennedy administration's approach--without mentioning the Kennedy administration--but with an important new contribution: the need for A.I.D. to use economic analysis to persuade political leaders to adopt policy reform.[64] In the days of Senator John Kennedy and Walt Rostow, there was little attention to the issue of how to persuade nations to reform -- the issue was to identify worthy nations by using objective criteria and then to aid them.

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[62]United States Participation in the Multilateral Development Banks in the 1980s, Department of the Treasury, Washington, D.C.: Government Printing Office, February 1982.

[63] A useful survey with a bibliography is Ernst & Young and SRI International, Successes in Private Sector Development, September, 1990, Bureau for Private Enterprise, Agency for International Development.

[64]Its author, Constantine Michalopoulos, then the Chief Economist of A.I.D., soon departed for the World Bank.

This Policy Paper and related research funded by A.I.D. in the mid-1980s concerned the political opposition to achieving reform that had been overlooked in the Kennedy era.[65] The Reagan Administration leadership of A.I.D. agreed on the need to study "lessons learned" and to devise reform initiatives different from the 1960s. In the 1960s, as will be shown in four case studies, in Taiwan, Korea and Indonesia, no opposition to reform had been tolerated by former generals Chiang Kai-shek, Park Chung Hee and Suharto. In India, the commitment to socialism was sufficiently strong to resist extensive personal pressure by President Lyndon Johnson. In the 1980s, however, economic reforms in democracies would face opposition. The slower the pace of policy reform, the more time there would be for the coalescing of groups opposed to it. The reform coalition could collapse. One idea of "policy dialogue" stressed that economic analysis can forewarn political leaders of both the benefits of reform and the risks during the multi-year implementation phase. For example, leaders should be prepared to deal with the way a comprehensive set of economic reforms may create political opposition in the legislature. Similarly, before protest demonstrations break out, political leaders should be prepared to popularize the benefits of the economic reforms and to seek political support for such reforms. This forewarning function may be vital to the media's understanding as well about what to expect from reform and how soon success will come.

The new A.I.D. research on lessons for "policy dialogue" also suggested that macroeconomic reform may be resisted because the reform package is misperceived as a externally-imposed austerity program. Few national leaders are trained market-oriented econ-

[65] A.I.D. began to support research and conferences at Harvard and elsewhere about the obstacles to implementation of economic policy reform, some of which are described in Merilee S. Grindle and John W. Thomas, Public Choices and Policy Change: The Political Economy of Reform in Developing Countries, Baltimore: Johns Hopkins University Press, 1991. In addition to conferences and research, A.I.D. funded several books on economic reform published by the International Center for Economic Growth (also funded by A.I.D.) which were disseminated to several hundred economic research institutions at conferences also funded by A.I.D. The Agency also supports economic research by the Institute for Policy Reform.There was no concealment of this extensive A.I.D. sponsorship. It is little known because incentives for scholars and World Bank staff to publish (and publicize) their work are strong, while the small cadre at A.I.D. familiar with economic reform has not been asked by Congress to report on its work due to Congressional lack of interest.

omists, nor will the local media have the knowledge to explain the benefits of economic reforms. A.I.D. research analyzed how in Zambia in 1984 economic reform was portrayed to the public as "satanic" suffering inflicted on an innocent nation by the "twin devils," the IMF and the World Bank.

The emphasis on "dialogue" and lessons learned included the need to educate the public prior to initiation of economic reforms. Fear of anti-reform backlash by an uneducated public has even caused A.I.D. recommendations for reform to be shelved by the local American Ambassador, as will be shown in the case study of Sudan in 1983. The case studies in the early 1980s of Bolivia, Peru , and El Salvador illustrate how A.I.D. sought to improve the intellectual climate about economic reform by funding public policy research centers. The work of such centers could lay the factual basis for national leaders to use in defense of policy reform by showing clearly and dispassionately its expected benefits.

Early in the Reagan administration, the A.I.D. Administrator sought to define a strategy that included economic reform in a February 1983 speech identifying "Four Pillars" of foreign aid:

1) Policy dialogue and Reform, seeking to agree with recipient governments on improvements that could be made to policy constraints;

2) Institutional Development, focusing on decentralizing and encouraging reliance on private and voluntary institutions rather than government;

3) Technology transfer, in such areas as biomedical research;

4) Greater use of the private sector in development.

The Reagan administration had returned to the Kennedy approach and its elevation of policy reform as a principal goal for A.I.D. as contrasted to the declaratory policy of the Carter administration about "basic human needs" or the Nixon administration delegation of reform to multilateral institutions. Another Reagan era document entitled "Blueprint for Development" re-emphasized the importance of correct economic policies as had been stated in "Approaches to the Policy Dialogue."[66]

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[66]U.S. Agency for International Development, The Strategic Plan of the Agency for International Development, Washington, D.C., June 1985.

The final Reagan administration A.I.D. document emphasizing economic reform was a much publicized report released in February 1989 and signed by the A.I.D.Administrator.[67] It featured a section prepared by two economists in the Office of Economic Analysis that contrasted the differences in growth rates of developing nations which followed "good" economic polices with those following "bad" policies. Three years later, the World Bank's annual World Development Report produced a similar, more detailed review of over sixty nations.

The Reagan administration did not limit to A.I.D. the mission of economic reform. It nominated a new President of the World Bank who shifted the policy of the World Bank increasingly toward economic reform as a condition of its loans and somewhat de-emphasized loans for "basic human needs." The Bank admitted its conditions often were not met in the period required. An authoritative history of the World Bank had concluded: "The Bank can ally itself with the development-minded elements in the country and reinforce their efforts. But the Bank's biggest handicap is its inability to guarantee that development-minded officials will come into power or remain in power."[68]

In the 1980s as a whole, the World Bank estimated that fully one fourth of all its new loans included such conditions. Nevertheless, under the Reagan administration neither A.I.D. nor the World Bank went to the extreme of refusing to aid nations which refused to implement "appropriate domestic policies."

THE BUSH ADMINISTRATION

Many observers in A.I.D. believe that if President Bush's first A.I.D. administrator not died of cancer, A.I.D. would have continued to emphasize economic policy reform following the report in February 1989. However, President Bush's second A.I.D. Administrator downgraded economic reform in a major re-organization. His public silence on the subject

[67] Development and the National Interest: U.S. Economic Assistance into the 21st Century, February 17, 1989, Washington, D.C., Agency for International Development.

[68] Edward S. Mason and Robert E. Asher, The World Bank Since Bretton Woods, Washington, D.C.: The Brookings Institution, 1973, p. 648.

contrasted with his predecessor's entr sm. As noted earlier, he abolished the Office of Economic Analysis and eliminated the position of Chief Economist whose occupant had reported directly to the Administrator in the Reagan administration. Although the Senate Foreign Relations Committee and the full Senate voted two years in row to request an annual survey of how well aid recipient governments were performing in the area of economic policy reform, the A.I.D. Administrator personally conveyed his opposition to Congress. Ironically, a rare Congressional initiative designed to stimulate greater interest in the progress of economic policy reform was not enacted -- at the request of an A.I.D. Administrator apparently uninterested in the subject and reportedly annoyed at an additional reporting requirement. One would have to return to the 1950s to find such a view.

We turn now to the case studies.

THE CASE STUDIES OF THE ROLE OF A.I.D.

TAIWAN 1960-65: JOINT AID INSTITUTIONS

A.I.D. obtained extremely successful results promoting economic growth on Taiwan for several reasons. The first was that the policy advice of A.I.D. fell on generally receptive ears both in the political leadership and among a few Western-trained and well-placed Chinese economists, especially after 1960. In the 1950s, however, Taiwan resisted U.S. pressure for several major reforms -- full devaluation, promoting exports, privatizing the monopoly state banking system, allowing foreign investment and reducing the state-owned half of the economy.

The second reason for success was that Taiwan permitted the creation, funding and staffing by American officials of four "joint" institutions operating outside the Taiwan government to administer an extraordinarily large economic aid program that, in the 1950s, reached as high as ten percent of Taiwan's GNP and accounted for half of all Taiwan's investment. In current American terms, this would amount to a foreign government receiving permission from the U.S. President to help spur U.S. economic growth by creating new institutions outside the federal government and spending $500 billion a year here. Obviously, the Taiwan-American relationship for economic reform was supported by President Chiang Kai-shek, who tolerated no serious political opposition and kept the military out of economic policy decisions.[69]

Before turning to Taiwan's economic circumstances and A.I.D.'s approach, it is useful to list the major actions A.I.D. supported with funds and advice on Taiwan:

1) The Taiwan dollar was repeatedly devalued in order to stimulate exports.

2) Anti-inflation measures reduced the inflation rate from 3,000 per cent in 1950 to 9 percent in the early 1950s.

3) Artificially high interest rates were fixed (briefly at 125 percent a year) to build savings.

4) A balanced or surplus government budget was maintained from 1950 to 1960.

5) All government expenditures were kept below 20 percent of GNP from 1951 to

[69]SRI International, The Taiwan Development Experience and its [illegible] Countries, Taipei: Kwang Hwa Publishing, 1988, p. 74.

1965.

6) High prices were set for exportable, labor-intensive products like asparagus, mushrooms, corn and sugar, but rice prices were kept low.

7) Industrial "parks" and a large export processing zone in Kaohsiung established in 1965.

8) The share of total national lending going to the private sector rose from 24 percent in 1953 to 77 percent in 1979.

9) Government loans for exporters were subsidized at one-half of market interest rates.

10) A.I.D. maintained a mission of 350 staff including consultants and Chinese employees, and a contract to support seventy economic consultants from a U.S. firm that identified economic opportunities for Taiwan in several sectors.

11) A.I.D. formed four new organizations jointly with the Taiwan government which were authorized to spend or loan U.S. aid and to propose economic activities eventually approved by the Taiwan government: the Economic Stabilization Board (in 1951), renamed the China Council for U.S. Aid (in 1958); the Joint Commission on Rural Reconstruction (JCRR); the Industrial Development and Investment Center (in 1959), which set up the first export zones in 1965; and the China Development Corporation (in 1959) which loaned to the private sector.

AMERICAN A.I.D. IN THE 1950S

In 1950, excessive inflation and the neglect of agriculture were seen by President Chiang Kai-shek and his economic advisers as the prime causes for their defeat by Mao Tse-tung. They decided to base their claim to "return to the mainland" in part on the economic success on Taiwan, after retreating there in 1949. In the 1950s, President Chiang listened both to American economic advice and to a small group of Western-trained Chinese economists who advocated applying a full package of economic policy reform to the island's economy, which had been a Japanese colony for fifty years. The five main steps were: tight controls on inflation, a balanced budget, tax reform, extremely high interest rates to attract private savings, and reform of the state-owned enterprises that accounted for half of the economy.[70]

It was not until 1960-1961, however, that A.I.D.'s most important efforts in promoting reform began on Taiwan. In an effort to overcome opposition that had been successful for years, a U.S. aid grant was offered for $40 million that was explicitly conditioned upon Taiwan adopting the export-oriented policy reform measures that had been refused in 1954 when an IMF mission to Taiwan tried to promote a currency devaluation. The IMF proposal that Taiwan refused in 1954 (written by two Chinese economists widely credited later for Taiwan's success) aimed at stimulating non-traditional exports to reduce Taiwan's dependence on sugar and rice exports which then accounted for 80 percent of exports.[71]

It was significant that A.I.D.'s long-term techniques succeeded in contrast to the failure of the brief visit of the IMF team. In 1960, Taiwan responded favorably to the ten American conditions, and even added nine more to them. That decision has been widely described as the beginning of the export boom that changed Taiwan's economic destiny.

THE RESULTS OF A.I.D. EFFORTS ON TAIWAN

One factor that had to be overcome was Chinese tradition favoring government enterprises over private enterprises. This pro-state bias was especially strong for senior Chinese military leaders on Taiwan who did not trust the local population of Taiwanese who would benefit most from private sector prosperity. Their perception was that the local Taiwanese majority had been influenced by their Japanese colonial masters for fifty years and did not share the

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[70] Two neoclassical interpretations are Bela Balassa, Development Strategies in Semi-Industrial Economies, Baltimore: Johns Hopkins University Press, 1982; and J. Fei, Gustav Ranis, and Shirley Kuo, Growth With Equity, The Taiwan Case, New York: Oxford University Press, 1979. Two studies which stress government intervention as the cause of Taiwan's growth are Stephan Haggard, Pathways From the Periphery: the Politics of Growth in the Newly Industrializing Countries, Ithaca, N.Y.: Cornell University Press, 1990, pp. 76-99; and Stephen C. Smith, Industrial Policy in Developing Countries: Reconsidering the Real Sources of Export Led Growth, Washington, D.C.: Economic Policy Institute, 1991.

[71] S.C. Tsiang, "Taiwan's Economic Miracle: Lessons in Economic Development," in World Economic Growth, edited by Arnold C. Harberger, San Francisco: ICS Press, 1983, p. 306). Tsiang was one of the two Chinese economists credited by Harberger for Taiwan's reforms.

fierce ideological dedication of Chiang Kai-shek's mainlanders, who saw Taiwan mainly as a base to use to re-conquer mainland China.

A book length study concluded on the basis of extensive interviews on Taiwan:

> By far the most important consequence of U.S. influence was the creation in Taiwan of a booming private enterprise system. Without the intervention of A.I.D., private enterprise would not have become, by 1965, the mainspring in Taiwan's economy. A.I.D. made the private sector flower both by financing projects that created external economies for the private investor, and by putting steady pressure on the Chinese government to improve the climate for private investment.[72]

A.I.D.'s successful role was also confirmed by Taiwan's Minister of Economic Affairs in a 1961 article. He stated Taiwan (and China) lacked experience with private enterprise, with corporate business, and with modern commercial practices. The three remedies for this lack of experience were the creation (with U.S. funds) of the China Development Corporation, the Industrial Development and Investment Center, and the export processing zones in Kaohsiung which were such a success that plans were made to set up similar zones all over Taiwan. The Minister credits A.I.D. in these words:

> U.S. aid played an important role in the development of private industry, not only because it has served as a major source of investment funds, but because it has encouraged and helped induce the flow of private capital into the channels of production.[73]

Annual per capita income in Taiwan rose from about $70 in the late 1940s to over $2,000 by 1980. During this period, real GNP grew annually at an average of 9.2 percent: 8.2 percent in the 1950s, 9.4 percent in the 1960s and 9.9 percent in the 1970s. Real GNP in 1980 was eleven times real GNP in 1952. By contrast, while Taiwan was a Japanese colony, its growth rate had been less than half this rate, about 4 percent.

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[72]Neil Jacoby, U.S. Aid to Taiwan. A Study of Foreign Aid, Self-Help, and Development, New York: Praeger, 1966, p. 138..

[73]Cited in Neil Jacoby, U.S. Aid to Taiwan. A Study of Foreign Aid, Self-Help, and Development, New York: Praeger, 1966. This book was based on Jacoby's lengthy evaluation for A.I.D. with a preface signed by David Bell that states it is the first major evaluation of an A.I.D. program.

During the fifteen years 1951-65, a total of $1.5 billion of American aid was spent on Taiwan, an average of almost $100 million a year in then-year dollars. Taiwan's population grew from 8 million people in 1951 to 13 million in 1965, and its GNP grew from $900 million to $2.4 billion by the time Taiwan "graduated" from A.I.D. in 1965. From 1952 to 1962, nearly half of the investment in Taiwan was financed by U.S. government aid. Almost no private foreign capital flowed into Taiwan before 1961. There were also substantial "multiplier effects" to U.S. aid because of the economic policy reforms Taiwan agreed to implement under pressure from the A.I.D. advisers. By one calculation, without the impact of U.S. economic aid, the level of per capita GNP of 1965 would not have been achieved until 1995.[74]

The United States created institutions outside of the Taiwan government to administer aid, and there was an unusual continuity of these institutions and their Chinese personnel. In March 1951, the United States suggested that the Minister of Finance head an "Economic Stabilization Board" to coordinate policies across ministries for trade and all economic policy. The justification for this super-ministerial unit was to fight the 3,000 percent hyperinflation. American aid officials not only attended meetings of the board but were actively involved in its work, without official membership.

It was important to A.I.D.'s success on Taiwan that American aid funds were administered outside the regular ministries and outside the government's regular budget. Through this unusual Board, all U.S. economic aid inputs could be coordinated closely with the Taiwan government's economic polices to control inflation and to direct public and private investment. The Board had several subcommittees in which U.S. aid officials participated by advising on decisions about monetary policy and foreign exchange policy.

The second unusual institution for administering U.S. aid on Taiwan was the JCRR, the Joint Commission on Rural Reconstruction. It had three Chinese and two American commissioners appointed by the presidents of the two countries. It served not only as the agricultural division of the U.S. A.I.D. mission in Taiwan but also as the de facto agricultural ministry of Taiwan. This unit also functioned outside the Taiwan government's regular

[74]Jacoby, p. 152.

bureaucracy, and could recruit and maintain a highly skilled and highly paid staff for two decades.[75] An A.I.D. memorandum in 1964 recommended that the JCRR be used in other developing nations.[76] The authors of this document wrote that the economic development of rural Taiwan was due "mainly" to the JCRR's success, to the JCRR's semi-autonomous nature, and its policy of using local organizations as project sponsors.

A.I.D. used its own funds to set up two other units that had important impacts on economic growth. The first in 1959 was an Industrial Development and Investment Center. In 1961, it set up one of the world's first tax-free and duty-free export processing zones at Keelung. This success resulted in a larger zone being set up in the southern port of Kaohsiung in 1965.

Besides the new institutions of JCRR, the Economic Stabilization Board, the China Council for U.S. Aid, and the Industrial Development and Investment Center, A.I.D. in Taiwan pioneered by using aid funds to establish the China Development Corporation (CDC) in 1959. The CDC board members were both government officials and private businessmen, and CDC could invest in equity securities. It obtained loans from the World Bank in 1962, and by 1965 had invested in 250 business firms. The CDC filled a vacuum because Taiwan's commercial banks during this period were controlled and could not make loans to businesses or purchase equity shares. Professor Jacoby concluded on the basis of extensive interviews:

> By far the most important consequence of U.S. influence was the creation in Taiwan of a booming private enterprise system. Without the intervention of A.I.D., private enterprise would not have become, by 1965, the mainspring in Taiwan's economy. A.I.D. made the private sector flower both by financing projects . . . and by putting steady pressure on the Chinese government to improve the climate for private investment.[77]

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[75]Dennis Fred Simon, "U.S. Assistance, Land Reform, and Taiwan's Political Economy, " in Edwin Winckler and Susan Greenhalgh, eds., Contending Approaches to the Political Economy of Taiwan. Armonk, N.Y.: M.E. Sharpe, 1988.

[76] See John T. Montgomery, Rufus B. Hughes, and Raymond H. Davis, Rural Improvement and Political Development. The JCRR Model. A.I.D., Washington, D.C., June 14, 1964.

[77]Jacoby, p. 138.

KOREA 1964-65: THE EXPORT PROMOTION PROGRAM

This case study describes eleven actions A.I.D. carried out in 1964 and 1965 that contributed to the remarkable reversal in South Korea's economic development strategy. In the 1950s, Korea had refused to accept U.S. economic advice to promote exports. What did A.I.D. do differently to get these results in 1964? What were the results?

By 1980, when Korea became one of the few nations ever to "graduate" from the U.S. foreign aid program, Korean annual trade had grown from about $400 million in the early 1960s to over $150 billion, due to its own efforts and to the openness to Korean products of the U.S. economy in the 1960s and 1970s. These results are all the more dramatic because of the devastation of the Korean war in the early 1950s, which left Korea with a per capita income of about $70, one of world's poorest nations, and on a par with India and Pakistan. Today, Korea is the sixth largest export market for the United States and the fourth largest importer of U.S. farm products. Korea has become an aid donor to over 90 nations.

Many accounts of Korea's economic success neglect the role of A.I.D. Yet Korea's growth is widely agreed to be due to its export surge, which began when Korea adopted a new strategy in 1964 which brought about "perhaps the most dramatic and vivid change that has come about in any developing country since World War II."[78]

Some national policy reform in the 1980s has required conditional cash transfers by A.I.D. that "buy" policy change. This was not the path in Korea. Inflation remained high in the 1950s, trade barriers were high, and the currency was overvalued. In fact, Korea had refused to accept much American economic policy advice from 1948 to 1963, during which time U.S. aid reached a peak of more than ten percent of Korea's GNP and actually exceeded total domestic savings in several years. In 1948, Korea would not implement reforms that were eventually implemented in 1964. The U.S. had no like-minded allies inside the Korean government, and it had to back down.. One American adviser at the time said, "More than once--over the essentiality of a Republic of Korea anti-inflationary policy, or the pricing of

[78] Anne O. Krueger, Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences, New York: National Bureau of Economic Research, 1977, p. 82; Anne O. Krueger, The Developmental Role of the Foreign Sector and Aid, Cambridge, Mass.: Harvard University Press, 1977.

aid goods to be sold on local markets or the underwriting of a non-essential public investment project--we have backed down from 'firm' positions."[79]

After 1953, South Korea feared it could not survive on agriculture alone (most industry and minerals were in North Korea), so President Rhee resisted American advice to stress exports and agricultural investment.as President, and he tolerated high inflation, budget deficits, and an overvalued exchange rate that provided no incentive to export.[80] Rhee's policies made sense in one respect because they did benefit his political supporters, especially those who owned industries protected behind a wall of high tariffs and an overvalued exchange rate. His cronies could profit from speculation. Nevertheless, the Eisenhower administration decided not to use its leverage and chose to tolerate Rhee's policies because of Korea's strategic importance.

When American economic advice was finally accepted in 1964, one crucial difference was the commitment of the Kennedy Administration which agreed that the A.I.D. mission director could suspend food aid in 1962 even after two bad harvests had placed Korea in a difficult position.. A second factor in 1964 was General Park Chung Hee, the newly elected Korean President whose legitimacy, after his illegal military coup, depended on keeping his election promise to correct the economic errors of the civilian government he had overthrown. A third factor may have been the dynamism and creativity of the A.I.D. employee who ran the program its first two years, judging by his book.[81]

Among the aspects of A.I.D.'s policy reforms in Korea, the most important was the export promotion project. According to Amicus Most who ran it, there were only "casual and uncoordinated relations" among the Korean government agencies responsible for foreign trade and the Korean private sector. There was no "overall programmatic and policy approach" to

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[79] John P. Lewis, Reconstruction and Development in Korea, Washington, D.C.: National Planning Association, 1955, p. 44

[80] GAO Report: Examination of Economic and Technical Assistance Program for Korea, FY 1957-1961, September 1962, PN-ABK-821.

[81] Amicus Most, Expanding Exports: A Case Study of the Korean Experience, Washington, D.C.: U.S.A.I.D., 1969.

exports.[82] There were no branches of foreign banks in Korea. The world was unfamiliar with Korean products, as might be expected for a nation known for centuries to its neighbors as the "Hermit Kingdom." As difficult as it may be to imagine today 30 years later, Most reported that "Korean businessmen had little or no contact with the outside world. . . .and the rest of the world had little knowledge of or faith in Korean products."

A.I.D. RESPONSE TO PRESIDENT PARK'S REQUEST FOR EXPORT HELP

Two years after the military coup of 1962, and in part because of a growing trade deficit that reached $229 million in 1963, the Korean military government decided to give a very high priority to export development. President Park Chung Hee publicly announced this high priority and instituted a monthly meeting at the Blue House at which he personally received the latest report on the export promotion program and made decisions on the spot to resolve export problems. Park had not sought or heeded American economic advice for the first two years of his rule. The U.S.-Korean Economic Coordination Commission did not meet from 1961-1963.[83]

The A.I.D. mission's approach was breathtaking in its comprehensiveness. The first two steps were the drafting of an overall export promotion program and the creation of new institutional arrangements. The Korean economy was already under close management by a Presidential super-ministry called the Economic Planning Committee. Its associated Economic Cooperation Council also had the personal attention of President Park. A new "Export Promotion Sub Committee" (EPSC) was created in March 1964. Surprisingly, in light of many nations' concerns for sovereignty and desires that donors must stay in their proper place, A.I.D. staff became members of the Export Subcommittee. In fact, the A.I.D. deputy mission director co-chaired it.

What was more important was the decision to form a "steering committee" of the

[82] Amicus Most, A.I.D. History of Exports 1964-1966, Seoul, 1964-66, October 1966, PIO/T 490-13-230-606-3-40101.

[83] David I. Steinberg, Foreign Aid and the Development of the Republic of Korea: The Effectiveness of Concessional Assistance, December 1985, PN-AAL-075, p. 29.

subcommittee to be co-chaired by a Korean Assistant Minister of Commerce and Mr. Amicus Most, the mission expert on exports. What made this arrangement so effective was that the steering committee set up a series of working groups. The rank and membership of the steering committee was also important. It included several vice ministers from other ministries, high level representatives of Korea's main banks, the President of the Korean export promotion agency (KOTRA), and from the private sector the heads of the four main business organizations.[84] All these groups knew the President and his Blue House staff would be waiting for the monthly progress report.

ELEVEN A.I.D. ACTIONS TO REFORM KOREAN EXPORT POLICY

Here is what A.I.D. actually did to facilitate reform of Korea's export policies:

1. A "campaign" of personal contacts by the A.I.D. mission staff explained to organizations of private sector entrepreneurs why they should now focus on exports instead of land speculation and construction. A.I.D. briefings explained the economic significance of the decision to establish a floating exchange rate n March 1964.

2. The joint A.I.D., public and private members of an "Export Promotion Steering Committee" met to propose immediate solutions to the most important obstacles discovered by its members. A feedback loop had been set up because unresolved issues were reported each month to the President of Korea, who decided personally how to resolve them, displaying his intense commitment to export promotion, and to following A.I.D.'s work and advice on the subject.

3. The Committee decided to skip over the bad Japanese export phase (from 1945 to 1950) when low-quality, very cheap goods were exported, because Japan needed many years to overcome a reputation for shoddy goods. Therefore, five steps were quickly taken:

a. A.I.D. brought in four consultants to work at the Korean Productivity Center.

b. The Korean National Industrial Research Institute, which was the government agency responsible for quality testing, was largely equipped with A.I.D. funds.

c. It was decided to set up an export inspection service and to require a government quality control certificate for certain commodities prior to export.

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[84] Jerome I. Udell, Report on KOTRA , September 1965 PN-ABK-586.

d. A.I.D. funded an advisor appointed to the export laboratory.

e. A.I.D. funded consultants to study quality control, the men's apparel industry, marketing, handicrafts, and to develop new ideas for agricultural exports such as canned and preserved fruits, vegetables and seafood.

4. A.I.D. set up export promotion programs in regional centers outside of Seoul. For example, in the fourth largest industrial city of Taegu, A.I.D. sent six consultants to improve productivity and quality control at the factory level. The city government contributed to a new building for an expanded laboratory for which A.I.D. funded the equipment. A.I.D. worked directly with city officials and sixteen leading industrialists, who formed an association and established their own productivity center.[85]

5. A.I.D. funded teams of Koreans from specific industries to visit nearby countries to study export promotion methods. Teams in quality control, the garment industry, handicrafts, and ceramics were sent to Japan, Taiwan and Hong Kong. Four Koreans were funded to attend the annual International Marketing Institute seminar in Massachusetts and other U.S. cities. All these teams prepared reports upon their return to pass on to others.

6. The A.I.D. mission prepared three studies to identify the sources of delay in the procedures and paperwork involved in exporting and foreign travel for businessmen. The Export Promotion Sub-committee even set up a "Procedures Committee" to reduce the amount of time required for exporting. A.I.D. was requested to supply a outside consultant for this work, too.

7. Legislation was drafted and quickly passed by March 1966 to set up an arbitration system to handle claims arising between foreign and Korean businessmen. A.I.D. supplied a consultant to work with the Korean Chamber of Commerce to establish the first Commercial Arbitration Association.

8. The Export Promotion Sub-committee recommended establishment of an export insurance system, and A.I.D. agreed to provide a consultant to assist in setting it up.

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[85]Inspection of Export Products in Korea, 1964 PN-ABK-581;Technical Assistance Project History and Analysis Report, A.I.D. Seoul, November 1964, PD-AAD-422-G1; Procedures Required for Export in Korea, December 1964, A.I.D. Seoul PN-ABK-617.

9. The A.I.D. mission persuaded the U.S. Defense Department to send a team from Washington to explore the prospects for increasing the quality of Korean products that the U.S. armed forces in Korea were purchasing. U.S. forces in Korea were purchasing many items from Japan and had never permitted Koreans to bid on them. Only about $35 million worth of purchases were made in Korea. As a result of this effort, these purchases doubled. The U.S. Army also worked with Korean companies to raise their quality standards so that the U.S. could purchase rubber tires, auto batteries, shrimp and many other products that the Koreans could now export as well. A.I.D. seems to have assisted also in facilitating increased Korean sales to the U.S. armed forces in Vietnam, nearly doubling Korean exports of services and products sold to support U.S. forces in Vietnam to about $50 million in 1966.

10. A.I.D. facilitated rapid growth of a new service export that generated millions of dollars and yen. The Korean tourist industry soon grew from a mere 1,000 tourists a year to become the second largest source of foreign exchange. The A.I.D. mission hired an American expert to diagnose the problems and prepare a master plan. In 1964 Korea lacked even one deluxe tourist hotel. Museums, cultural sites, restaurant menus for foreigners, and tourist shopping facilities all had to be developed. Japanese tourists would be the best early market.

To promote tourism, A.I.D. had to work through the Ministry of Transportation because it directed the Korean Tourist Service, which in turn owned and operated the few tourist hotels. A.I.D. learned that a crucial obstacle was that Korea was not a "free stop" under the rules of the International Air Transport Association. Early in 1965, A.I.D. mission staff met with the leading wholesale ticket agents of the Pacific Air Transport Association who agreed to pass a resolution at their convention so Korea could receive stopover tourists along the route between Japan and Hong Kong.

A.I.D. mission staff went even further to promote tourism to Korea by writing to the three leading U.S. hotel chains (Hilton, Intercontinental and Sheraton) and then accompanying the head of the Korean overseas trade agency to the United States to visit the headquarters of each hotel chain, who agreed after the meetings to send representatives to Korea.

11. A.I.D.'s direct action included identifying foreign buyers of Korean exports. A product-by-product marketing survey resulted in the naming of 35 "product chiefs" appointed by the Commerce Ministry and the Foreign Ministry. Each of the 35 "chiefs" was required to

submit reports to his working group of the Export Promotion Steering Committee, each of which had an A.I.D. technical advisor. American department store chains were identified in A.I.D. studies to be good export markets. So, in October 1965, the A.I.D. mission's export expert accompanied his fellow steering committee member (and the head of the Korean overseas trade promotion agency) to the United States where they successfully persuaded senior representatives of Macy's, J.C. Penney, W.C. Grant, Sears Roebuck, Montgomery Ward, the May Company, Allied Stores and Woolworth to travel to Korea, together. After that trip, many stores opened purchasing offices in Korea.

In conclusion, the success of this case can best be understood in terms of the way that institutional arrangements energized a Presidential decision. A.I.D. experts and consultants did not just diagnose problems. They were able to be part of the solution because of the institutional power of the steering committee and the monthly reports due to the Blue House. The A.I.D. export promotion advisor pointed out in his report in 1966 that much of the program's success was due to the requirement that he and his Korean counterparts had to prepare an annual master plan for the following year's export promotion program in which they could incorporate their diagnosis and prescriptions. From our perspective nearly three decades later, we can see that the joint drafting of such a plan was another example of how the unique institutional arrangement A.I.D. set up helped to facilitate its close role in implementing a Presidential decision to promote exports.

INDIA 1965: THE ROME AGREEMENT ON AGRICULTURAL REFORM

The success stories of A.I.D. in Korea and Taiwan do not prepare the reader for this bizarre case study of A.I.D.'s efforts to reform India's economic policy. Korea and Taiwan resisted some economic reforms in the 1950s. However, their resistance was nothing compared to India's. Since independence in 1947, Indian leaders believed zealously in a strongly inward-oriented development strategy. Among democratic nations, India has been the "closest imitator of the Soviet planning model,"[86] according to A.I.D. economist James Fox. A.I.D. has been unable to change India's general preference for socialism. However, this case study shows that Indian agricultural policy was significantly reformed in 1965. In the nearly thirty years since then, Indian agricultural performance has been good, perhaps the most impressively performing sector of its economy.

How did A.I.D. do it? From 1958 to 1965, U.S. program loans and food aid to India were without conditions; between 1962 and 1966, "self -help performance rates" were fairly low; and, for the balance of the 1960s, the U.S. let the World Bank assume "the principal role for conditioning of . . .assistance," of which the U.S. provided about 40 percent.[87] Thus, other than in 1965, the U.S. may have assumed that economic policy reform in India was not feasible. This makes what happened in 1965 all the more interesting. Some observers even believe A.I.D. has been compelled by India since at least 1970 not to press economic reform issues.[88]

A.I.D. sought in the early 1970s to influence India by funding a series of economic studies that included demonstrations of how India could substantially increase economic

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[86]James Fox, Hans-Peter Brunner, Carlos Pelay, "Export Promotion and Investment in India," Center for Development Information and Evaluation, A.I.D., February 1991.

[87]The Use of Program Loans to Influence Policy, Evaluation Paper 1A, Part 1 Summary and Conclusions, March 1970, PN-AAQ-813, p. 12.

[88]The Indian liberalization in 1992 has been widely portrayed to be the result of opinion changes in India's leadership and strict conditions that the IMF required to assist India with its balance of payments problems. The Economist has suggested the reforms are not a complete liberalization like Bolivia in 1985 or even China in 1978-88.

growth and exports. Instead, Indian economic policy turned further inward in the 1970s.[89] The reforms India refuses are further tariff cuts, elimination of inefficient subsidies, non-tariff barriers to imports, and providing major incentives to the private sector for exports.

This case study examines a success A.I.D. had in India in 1965 because it is instructive on the point of just how far a nation's leadership can resist economic policy reform. This is the only time an American president became personally involved in A.I.D.'s efforts to promote economic policy reform. Lyndon Johnson not only sent his Secretary of Agriculture to investigate the need for reforms, but also personally warned the Indian leadership of his seriousness. He then cut off American food aid in order to persuade India to accept the reforms, even though India was suffering from a two-year drought and facing widespread famine.

Fortunately, how the reforms were achieved is clear because both John Lewis, then the A.I.D. mission director in New Delhi, and President Johnson have written memoirs of what they did. Lewis, as the chief A.I.D. representative in India, knew that the powerful Indian Planning Commission was against excessive allocations to agriculture and favored industry, based on the dominant development economics of the time which recommended "extracting" surplus from agriculture for industry, not investing in agriculture.

For many years, a dissenting view came from the staffs in India of A.I.D.'s precursor (the Technical Cooperation Mission), from the Ford Foundation and the Rockefeller Foundation. This dissent originated in the early 1950s in India's own Ministry of Food and Agriculture where it was designed by Dr. S.R. Sen. Sen unsuccessfully proposed, from 1952 onward, raising the priority of agricultural investment, establishing higher price incentives for farmers, dismantling food controls, and establishing a buffer stock to cushion food price fluctuations. Sen's proposal was not adopted until A.ID. and President Johnson pushed it. Then, in December 1965, an additional provision for more investment in fertilizer was also made for new, high-yielding varieties of food grains. It was not the Rockefeller Foundation or Ford Foundation or even A.I.D. alone that persuaded India to raise the priority of agriculture

[89]Even the major reforms of 1991-92 may include only roughly half of what should be done, according to The Economist magazine.

against the wishes of the Planning Commission's powerful supporter, Prime Minister Nehru, a firm non-Marxist socialist. A precondition for the reform may have been the death of Nehru in May 1964.

The actual "battle" for reform lasted from after Nehru's death through November 1965 when a new agricultural strategy was announced in Parliament and the U.S. provided a loan. In Lewis' view, "the year (1965) had anything but a tranquil story line: it included a drought, a war, and the beginning of some quite extraordinary Presidential behavior."[90]

Lewis sent a memorandum to Ambassador Chester Bowles proposing that U.S. aid to India should be increased -- as much as double to the per capita level Pakistan was then receiving -- because "a faster pace of liberalization reform could not be expected until the country had more foreign exchange cushioning," and proposed that the Agency ponder seriously whether India might not be ready for the kind of "big push" therapy that A.I.D.'s chief economist and Assistant Administrator for Programs, Hollis Chenery, had been hypothesizing."[91] A.I.D. Administrator David Bell was in favor, along with the NSC staff aide for India Robert Komer, and successive NSC advisers McGeorge Bundy and Walt Rostow. Lewis explains "this majority upbeat (on India) school might have prevailed at will had it not been for one thing: the President of the United states was a member of the minority." The President had learned of another estimate that harshly criticized India's performance, stating that, "3. India's key failures have been in fertilizer, pesticides, producer incentives, credit, and seed varieties 4. . . .Better performance will require a dramatic approach . . . .5. The U.S. must use all possible leverage to improve India's performance."[92]

President Johnson suspended the making of fresh economic aid commitments. Aid had already been suspended to India and Pakistan in September 1965 to try to bring a their brief

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[90]John P. Lewis, Policy Based Assistance: An Historical Perspective on A.I.D.'s Experience and Operations in India/Asia in a Bilateral and Multilateral Context, PN-ABC-996, July 1989, p. 15.

[91]Ibid., p. 16. Lewis states that a declassified version is available at the LBJ Library, Austin, Texas.

[92]Ibid., p. 19, quoting Under Secretary of Agriculture's memorandum to President Johnson of October 23, 1965 on file at the LBJ Library, Austin, Texas.

military conflict to a halt.

The result was that at a meeting in Rome (of the Food and Agriculture Organization) the U.S. Secretary of Agriculture and his Indian counterpart produced a written agreement, kept secret for many years, promising a 40 percent increase in agricultural investment in the coming year and some increase later. There were also specific targets for fertilizer tonnages and acreage for intensive areas, and both price polices and credit policies were to be reformed.[93]

President Johnson authorized release of 500,000 tons of wheat and a new $50 million loan for fertilizer. Lewis in New Delhi wrote to Komer on the NSC staff that "certainly the timing and probably the content of the new program owe much to U.S. pressure."[94]

President Johnson's account begins after he returned from his tour of Asia in May 1961 as Vice President when he visited India for the first time and saw "abject poverty." He suggested to President Kennedy that conditions should be put on aid to obtain more efforts from the recipient nations:

> "It would be useful," I suggested, "to enunciate more clearly than we have. . . what we expect or require of them. I remembered that advice four years later when I was called on to help India meet its worst threat of starvation in a hundred years. . . .I knew that millions of people might starve unless we acted. But I had to think of more than the humanitarian side of this matter. . . Against our advice over the years, the Indian government had systematically neglected agriculture. . . .The Indians had been pouring most of their energy and resources into a strenuous campaign to build a major industrial base. . . But it was folly. . . to build an industrial nation on the foundation of a weak agriculture.

Johnson next reveals another point on his mind about policy reform. "Members of Congress were complaining that American aid encouraged some underdeveloped countries to delay helping themselves." For these reasons, President Johnson decided on a course of severe pressure:

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[93]Ibid., p. 22. Lewis notes that the Rome agreement is in the NSC History file at the LBJ Library, Austin, Texas.

[94]Ibid., p. 23.

> My first action in the fall of 1965 was to put food aid to India on a short term basis. . . .What we called the "short tether policy" was profoundly unpopular among India's leaders. . .It was hardly more popular with those in our own government. . . . I stood almost alone, with only a few concurring advisers, in this fight to slow the pace of U.S. assistance, to persuade the Indians to do more for themselves, and to induce other nations to lend a helping hand. This was one of the most difficult and lonely struggles of my Presidency.

President Johnson account reinforces Lewis' assessment that there were reform allies inside the Indian government. Johnson wrote:

> Fortunately, a handful of officials in New Delhi were pressing...for exactly the kind of changes I felt were necessary. One was the capable Minister of Food and Agriculture...In November 1965, he and Secretary of Agriculture Orville Freeman met in Rome and worked out a new understanding on Indian agriculture....The India government accepted the Rome agreement and announced its new farm program on December 7, 1965....I gave Secretary Freeman instructions in a telephone call on the morning of December 11. Move the wheat, I told him.....This effort did not involve trivial sums. In 1967, India needed 10 million tons of food grains, which cost roughly $725 million.

LBJ also makes clear that next year, in 1966, he did not trust the Indians to follow through on implementation of the agreement. He wrote:

> We held up grain shipments from August to December 1966. In November Secretary Freeman sent several experts from the Department of Agriculture to India to make an independent estimate of the harvest. . . . During this period our policy was the target of a heavy propaganda barrage. . . .I was pictured as a heartless man willing to let innocent people starve. . . . I recognized that only a handful of specialists in the United States and India understood what we were trying to accomplish. . . .We would enter a consortium arrangement with other countries...through the World Bank or some other multinational agency. . .India's supply of fertilizer had increased by almost 80 percent in 1966-1967 over the previous year. Indian farmers were also beginning to use more fertilizer and pesticides than ever before. They were also beginning to use new high-yield seeds. The result was a bumper crop, the largest in India's history.[95]

The U.S. had sent 14 million tons of grain to India in the two years of the drought, enough to feed 50 million people in 1965-66 and 40 million the next year, in two ships a day

[95]Johnson, Lyndon Baines, The Vantage Point: Perspectives of the Presidency, 1963-1969, New York: Holt, Rinehart and Winston, 1971, pp. 222-230.

for a year, amounting to one fifth of the wheat raised by U.S. farmers each year.

India not only "required" this much pressure for a 40 percent increase in its agricultural investment (under the Rome agreement), but the Indian government in 1966 also managed to demand that George Woods, the President of the World Bank, must raise an additional $900 million annually in aid to India if India was to liberalize its trade policy. Woods made the promise, and India devalued the rupee by 36.5 percent. Lewis believes that this was justified, "It was legitimate, the donors agreed, for the Indian liberalizers to demand that kind of cushioning. Such was the central theory of the Woods-Mehta deal in the spring of 1966, and, as noted, the Indians to a man and many of us on the donor side understood that the $900 million non-project package was to continue for several years."[96] Lewis admits that India did not continue to liberalize much. High tariffs, exchange controls and multiple barriers to exports continued in place after 1966, until further (but not complete) liberalization occurred due to pressure from the IMF in 1991-1992.

Looking back, 30 years later, it is apparent India's failure to advance far on the reform path has cursed it to fall behind the rest of Asia and other parts of the developing world. For example, in the early 1950s, India's steel production was 1.5 million tons, not far behind Japan and ahead of all other developing nations. Per capita electricity production surpassed that of Korea and Thailand. That made India by far the largest electricity producer in the developing world 40 years ago, but today it is far behind.[97]

India has fallen relative to other developing nations as judged by many criteria. Exports, for example, were flat from 1950 to 1971 and did not grow between 1976 and 1985. Why has India been left behind by the rest of Asia? Perhaps because India has been the closest imitator of the Soviet economic planning model of any democratic country. By Asian Development Bank estimates, India's ratio of capital to output is so bad that it takes twice as much capital to produce a given increase in output as in most other developing nations.[98] At

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[96]Lewis, op. cit., p. 37.

[97]Deepak Lal, "India," International Center for Economic Growth Country Study 5, ICEG, 1988, p. 19.

[98]Asian Development Bank, "India," Asian Development Outlook, 1990.

least 25% of India's industrial employment is from government-owned companies.

Some economists have calculated that if India's rigid national economic policy were reformed, India could grow at 9-10 percent annually. By developing country standards, India's national savings rate is quite high at 20 percent, and the ratio of investment to GDP has risen from 12% in the 1960s to 18% in the 1970s and to 24% in the late 1980s. If India's capital/output ratio were improved to bring it to levels close to those of Korea and Taiwan, its current investment level would yield annual growth of 9-10%.[99] In other words, during the past three decades India's economic growth rate of 4-5% reflected only growth in inputs of labor and capital, not any increase in productivity. In fact, India's total factor productivity growth has been calculated between 1960 and 1980 at between minus 0.2% and minus 1.3% per year. India's investment efficiency is very low.[100]

What is wrong with India's economic policy? India has been one of the most closed economies in the world since 1950. Even after tariff reform in 1991, the average tariff level still exceeded 100% (compared to 20% for Mexico), most imports must be approved by the government on a slow, case-by-case basis, and foreign exchange is tightly controlled. In fact, until recently, all export earnings had to be returned to the central government bank to be converted into highly overvalued rupees that have never been a convertible currency. It often takes 6 months to obtain central government bank approval to spend foreign exchange, even for small items.

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[99]Ibid.

[100]John Echeverri-Gent, "Economic Reform in India: A Long and Winding Road," in Richard Feinberg, et al., Economic Reform in Three Giants, Washington, D.C.: Overseas Development Council, 1990; Jurgen Wiemann, India: Self-Imposed Restraint of Development Potential, Berlin: German Development Institute, 1988.

INDONESIA 1982: THE TRADE REFORMS

A.I.D. in 1982 funded the analysis of the need for a sweeping reform of Indonesia's trade and financial system. Prior to these A.I.D. studies, Indonesia since 1966 had already undertaken useful but incomplete trade reforms. In 1966, the rupiah was devalued and foreign exchange controls loosened, then eliminated entirely in 1970. Under Sukarno prior to 1966, exports and foreign investment was kept low by a frustrating system of licenses, foreign exchange controls, and multiple exchange rates according to the nature of the transaction. Consequently, exports and new foreign investment was minimal.

Results were seen in the second half of the 1980s, when Indonesia's non-traditional exports tripled.[101] The Indonesian economy had suffered an unfortunate fifteen years from independence until 1967 when its flamboyant President Sukarno was replaced in a military coup by General Suharto. Since 1967, scholars and reporters have credited "the Berkeley mafia," a small group of Indonesian economists, with the successful maintenance of a stable economic policy environment for twenty-five years. Per capita income has more than tripled. Oil revenues assisted this growth, but oil and natural gas revenues declined between 1980 and 1988 from 70 percent of central government revenue to about 40 percent after the decline of oil prices began in the 1980s and as other Indonesian exports grew rapidly.

In 1982, A.I.D. correctly diagnosed that Indonesia would have to massively stimulate exports other than oil and natural gas. A multi-year A.I.D. project provided $4.5 million for special studies and consulting services aimed at improving the business climate by strengthening institutions responsible for policies and services affecting the private sector.[102]

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[101] "Indonesia Case Study," Economic Reform Today, Fall 1991, pp. 5-11. This study by The Futures Group and the Center for International Private Enterprise provides a detailed chronology of the Indonesian reforms.

[102] Export Promotion in Indonesia, A.I.D. Technical Report No. 6, Center for Development Information and Evaluation, Washington, D.C, April 1993, PN-AAX-263. The World Bank has had an Export Development Project with the Ministry of Trade for $51 million in export credits and $13.5 million in export promotion technical assistance. The UN Development Program also has several training projects with the Ministry of Trade.

The goal to was to move Indonesia toward tax reform, stock market development, improved central banking, and an export-orientation, and away from its past dependence on oil and gas exports.[103]

Indonesia's phased deregulation and liberalization of trade and investment was quite successful, particularly by the late 1980s. With a freely convertible currency and a liberal business environment that welcomed foreign investment, Indonesian manufactured exports to industrial countries tripled from about $2 billion in the mid 1980s sharply and steadily upward to about $6 billion by 1990, including a wide variety of products like furniture, clothing, plywood, paper, glass, rubber and shoes. Meanwhile, oil and gas exports fell to half of total exports to industrial countries. The United states has been Indonesia's largest single market, accounting for 30 percent of its exports.

The A.I.D. funded special studies pointed to the need for reforms which Indonesia implemented quickly. In international trade, there was liberalization or reduction of tariffs, non-tariff barriers, quantitative controls, licensing requirements, sector exclusions, and complex customs procedures. In an almost unprecedented step, Indonesian customs was sub-contracted for several years to a Swiss firm to expedite clearances and halt corruption.[104]

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[103] Ibid., pp. 7-8. Other parts of the project brought the total to $9.6 million including $500,000 for the Indonesian Executive Development Fund of the Ministry of Finance to send mid-career Indonesians to U.S. business schools. Two million dollars facilitated private foreign investment in the early 1980s by strengthening BKPM, the Indonesian Investment Coordinating Board, to facilitate joint ventures between U.S. and Indonesian companies. Other donors in this area included UNIDO (UN Industrial Development Organization), the World Bank, and the Canadian Development Agency.

[104] "Section C: Deregulation and Export Incentives," Working Paper No. 151, 1993, Center for Development Information and Evaluation, A.I.D. Library, Rosslyn, Virginia.

SUDAN 1983: A CLASSIC POLICY DIALOGUE

Sudan is one of the world's poorest nations. It also has a highly government-controlled economy. This case took place in 1984, before Islamic fundamentalists took over Sudan. It shows how several price subsidies which distorted the Sudanese economy were corrected solely through A.I.D.'s providing economic analysis to the Sudanese Finance Minister. A.I.D.'s economic analysis and the need to list "self help measures" were all that one A.I.D. economist needed to bring about the elimination of inefficient price subsides in wheat and diesel oil.[105]

Fred Winch was the Associate Director for Economic Policy at the U.S. A.I.D. Mission in Khartoum, Sudan in 1983 and half of 1984. He has provided a rare firsthand account of about how an A.I.D. mission can carry out "policy dialogue" just as it is recommended in A.I.D.'s Policy Paper, "Approaches to the Policy Dialogue," which remains the classic account on this subject.[106] The fact that a military coup in Sudan later destroyed these economic reforms in no way undercuts the achievement clearly due to A.I.D. intervention.

Three factors set the context for Winch's success in Sudan.

1) The total U.S. aid program of $200 million annually exceeded the World Bank's, which provided easy access for A.I.D. staff to senior decision makers.

2) Sudan had defaulted on an IMF stand-by agreement and was no longer in contact with the IMF, leaving the fields of fiscal deficits and currency devaluation open to A.I.D., although they are sometimes claimed to be appropriate for "dialogue" only with the IMF. The Sudanese initially took the position that macroeconomic conditionality could not be a covenant in an A.I.D. bilateral agreement, but they eventually dropped this view.

3) The quality of Winch's economic analysis was persuasive. In one important case,

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[105] American food aid legislation (set up in the Kennedy administration with George McGovern as its first director) requires "self help measures" to be included in written agreements with the recipient governments.

[106] Fred E. Winch, "How USAID Has Initiated and Encouraged Economic Policy Reform in the Sudan," Paper Prepared for the AID Economists Conference, Annapolis, Md., November 1984, PN-AAV-004.

Winch's analysis differed from that of the IMF and was more persuasive to the Sudanese. In the diesel study, the Finance Minister himself spent several hours going over the study with the A.I.D. staff and ultimately accepted the conclusion that raising diesel prices would end the scarcity and be more efficient for all concerned.

This account illustrates A.I.D.'s "policy dialogue" approach-- using economic analysis presented to cabinet officials to cajole reform. The case also shows the importance of empathy and timing by someone with a skillful "feel" for bureaucratic factors. Sudan in 1983 had an overvalued exchange rate. Prices of important things like bread and diesel fuel were heavily subsidized.

Fred Winch decided to obtain data to determine the cost-price structure for bread. He concluded that bread was being subsidized by as much as 30%. At the same time, a large assistance program was providing wheat at $50 million a year. He met with officials from the Ministry of Commerce, Cooperation and Supply (MCCS), the government body responsible for importing wheat and establishing the subsidized prices. Based on the interview, Winch determined that the budget subsidy was approximately $30 million a year at the prevailing official exchange rate. He presented these facts to the Mission Director who recommended he present justification for eliminating the budget subsidy at the next meeting of the U.S. Embassy Economic Council.

Unfortunately, after this discussion, the U.S. Ambassador decided that A.I.D. should not pursue the proposed price change. He did not want the U.S. Government to be responsible for a bread price increase. Winch went back to the drawing board: "I decided I had made a strategic error . . .(P)ositive economics could not be sold to the Ambassador." It was clear an alternative approach was required: a political economy framework. A well-known economist from Stanford University then worked for the A.I.D. Mission as a consultant on agricultural policy. The consultant from Stanford recast the presentation to give more weight to the political benefits, and he presented the case again to the Ambassador, who was not an economist. This time he approved.

In July 1983, the Sudanese government decided to remove the $30 million bread subsidy. This was accomplished by reducing the size of a loaf from 320 to 230 grams. This decision required five negotiating sessions with A.I.D. to demonstrate the benefits of ending the subsidies in order to cut the foreign exchange costs of wheat imports.

Winch next decided to tackle the implicit foreign exchange rate subsidy, which resulted in a hidden tax built into the wheat price structure due to an overvalued exchange rate. At the end of this next round of negotiations, the Minister of Commerce decided to hold the nominal price fixed but reduced the size of the loaf again from 230 to 170 grams. This agreement to eliminate the implicit foreign exchange rate subsidy was a self help measure for the P.L. 480, Title III $30 million program, under which the government agreed to cut the loaf size, thereby increasing the price per gram.

Further analysis showed that domestically produced wheat was underpriced. By showing these calculations to the Ministry, an agreement was reached to raise that price too. Winch's investigations a few months later showed that the Food Research Center at the University of Khartoum had undertaken a pilot project on the feasibility and economy of mixing sorghum with wheat flour for bread making. This composite flour for commercial bread making was also made a self-help measure for the next P.L. 480 agreement. A commercial trial was conducted of the composite flour among private sector bakers for six months. A.I.D. agreed to provide local currency support for this trial. These self-help measures were written into the $20 million P.L. 480 agreement. The new mix was adopted nationwide.

Winch next calculated that agricultural exporters were being harmed by the overvalued exchange rate. During A.I.D.'s next negotiating session with officials from the Ministry of Commerce, Cooperation and Supply, the Ministry informed A.I.D. that the issue of the exchange rates could only be discussed with the IMF. Winch took the position that economic analysis could not be undertaken without consideration of the exchange rate. At the next negotiating session, Sudanese ministry officials argued that if farmers were paid higher prices they would produce less. In the end the Ministry agreed to a 25 percent increase in the price for groundnuts (peanuts), sesame, and gum arabic.

The final self-help measure agreed to under the Title III negotiations was to insist on the involvement of the private sector millers in inland transport instead of the inefficient public sector. A.I.D.'s meetings with the private millers indicated they wanted a Millers Federation both to deal with the private trucking industry and to get the government out of the wheat import business. These reforms were agreed to by the Sudanese government.

Winch then analyzed petroleum, the most important import influencing Sudan's productive capacity and 25 percent of the import bill. The government rationed petroleum consumption and fixed its retail price below the international price. But Sudan could not meet its obligations under a $9 billion debt, so it had no credit to import petroleum. The black market provided petroleum at prices 2-3 times the administered government level. Winch estimated that the total loss due to these controls on petroleum was $100 million annually.

A.I.D. proposed a policy reform of purchasing fuel by competitive bidding of retailers, while moving the price of diesel off the overvalued official exchange rate to the higher free-market rate. This idea was accepted in principle by other donors and the Sudanese government.

All these reforms had been achieved by the use of economic analysis, which was accepted by a receptive if skeptical Sudanese leadership. The next regime in Sudan was installed by a military coup by Muslim fundamentalists, which restored socialism. The exchange rate became highly distorted, price subsidies were restored , and Sudan remains in arrears on international loans.

DOMINICAN REPUBLIC 1970-1985: THE EXPORT PROCESSING ZONES

Free Trade Zones (also called Export Processing Zones or EPZs) have proliferated in the developing world over the past two decades. The western hemisphere's most successful free zone program, made possible by A.I.D. support, is in the Dominican Republic. Zone employment has risen from insignificant levels in 1972 to 70,000 direct jobs and 100,000 indirect jobs. This represents about 7% of the economically active population of 2.4 million Dominicans in a country of over 7 million.

Twenty years after the first zone was created in 1970, total exports from all the zones reached $500 million, which is a large percentage of total national exports. These exports have helped to offset unavoidable, major losses of traditional exports like sugar due to world price declines.

The zones are islands of stability and free market principles in contrast to the changing rules of the game in the rest of the country. Since 1960, the Dominican economy has undergone a surprisingly successful economic diversification in part due to the free trade zones. What was once an agricultural economy now has 17% of the GDP in light manufacturing and 45% in services. The booming free trade zones and foreign tourism account for much of this success.[108]

A.I.D. has had a worldwide role in supporting EPZs. The total number of nations with EPZs grew from only 10 countries in 1969 to more than 145 zones in operation in over 45 countries by 1990.

A.I.D. and the World Bank support a standard EPZ incentives package that includes many of the economic policy reforms a whole nation ought to have. In an EPZ, the reforms are limited to a very small, often isolated area. They include::

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[108] U.S.A.I.D. Project Paper "Industrial Linkages, Dominican Republic," September 1989, PD-AAZ-325; J.E. Austin Associates and Arthur Young and Co., Private Sector Strategy Assessment: Dominican Republic, October 1988, PN-ABC-087; U.S.A.I.D. Project Paper "Export and Investment Promotion, Dominican Republic," August 1985, PD-AAS-410; U.S. Department of Agriculture and U.S.A.I.D. Bureau for Private Enterprise, Guidebook on Free Zones, 1984, PN-AAT-559.

1) Large tax reductions for business expansion,

2) Exemptions from customs duties on all imports used for export production,

3) Relief from all foreign exchange controls,

4) One-stop regulatory approval centers,

5) No limits on foreign-owned firms repatriation of profits; and

6) Private sector operation of infrastructure normally run by the public sector.

In 1970, the cautious Dominican Republic authorities, as in many countries, were at first willing to apply these "drastic" export-promotion policies to only a small fraction of their territory by designating a free zone. As we have seen elsewhere, skeptical policymakers have often opposed proposals to liberal economic policies. Their faith in governmental controls on the economy cannot be shaken. There is usually broad political support to maintain the status quo. After the success of the first zone, however, at least some policymakers begin to see the light. They may agree to permit more zones. The Dominican Republic's single zone in 1969 eventually led to approval of 15 more zones.[108]

This slowness in policy reform is due to political disputes many developing nations face. Some leaders may be ready for nation-wide policy reform, while other equally influential leaders either fear the consequences of failure or doubt the validity of applying export promotion or free market principles. In the Dominican Republic, rather than force a dangerous and divisive test of strength, A.I.D. proposed establishing a small, remote export processing zone to serve as an empirical experiment. Opponents of the free market and privatization (who benefit from import substitution and other economic distortions) did not object. Opponents of policy reform underestimate the inherent dynamic in export processing zones that will built a constituency for further policy reform. Eventually, however, the success

[108]Frank Delzio, "Dominican Republic: Initial Assessment of the Potential for Backward Linkages With Free Trade Zones," February 1989, Washington, D.C.: International Science and Technology Institute, Inc, PN-ABG-735; Arthur Young and Co., Impact on the Poor of U.S.A.I.D.'s Private Sector Programs in the Dominican Republic, April 1989, Reston, VA. PN-ABD-097

of the free trade zone experiment affected an entire nation.[109]

Policy reform through free trade zones is based on the concept of a feedback loop. The feedback system produces information over time on both positive and negative outcomes of policy steps. A possible slogan could be "nothing succeeds like success."[110] As in the Dominican Republic, those who invest or work in the small zone obtain its benefits. Those who prefer rigid government regulations and price subsidies may stagnate in their larger region of the country, hiding behind their high tariffs while the smaller zones grow visibly more prosperous.

The Dominican Republic showed skeptics of economic policy reform can be won over under five conditions:

1) an export processing zone is created,

2) private firms located in it are highly profitable,

3) government tax revenues from workers in the zone grow rapidly,

4) non-traditional exports grow that otherwise had seemed impossible, and

5) a constituency forms to pressure the government for additional zones.

A.I.D.'s work on free trade zones did not begin in the Dominican Republic in 1969, but in Taiwan. In the early 1960s, some officials in Taiwan, with A.I.D. advice and funds pioneered by opposing the view that Taiwan could never become a manufacturing or

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[109]James W. Fox, A Strategy for Export-Led Growth in the Caribbean Basin, LAC/DP, Agency for International Development, November 8, 1989, PN-ABD-926, pp. 4-5. This paper pioneered the concept that EPZs function as policy reform feedback loops. On p. 12, Fox writes, "any evident success in exporting is likely to help reinforce policy commitment. The existence of existing returns to scale is sufficient grounds for subsidies on economic efficiency grounds. The subsidies will pay for themselves. . . . More generally, one can envision a process of export development and policy reform that achieves the economist's preferred policy framework . . .in the long run through interventions that cause the private sector to push policy in the desired direction."

[110]Ibid., p. 26-27. Fox adds, "Lauding the progress that has been made -- for example, closely tracking and continually publicizing the number of jobs, investments and exports resulting from the new strategy -- is essential to building the constituency and showing results. Equally important is talk of impending doom if some needed action. . . is not immediately taken by the government."

exporting economy. By the 1970s, Taiwan's tiny, two-mile-square export processing zone generated $3.5 billion a year of foreign exchange. This is the kind of feedback that changes minds. Those whose faith rests in high tariffs, import prohibitions, and the nobility of state-owned enterprises may be undermined by the demonstration effect of EPZs.[111]

The World Bank followed A.I.D.'s pioneer efforts to support in EPZs. The Bank now provides loans for many EPZs, including those in Jamaica and the Dominican Republic. A.I.D.'s success in forming zones almost 30 years ago in Taiwan, Singapore and South Korea has had a worldwide impact.

The steady growth in the free trade zones stands in contrast to changes in economic policy pursued by successive presidents since the death of Trujillo in 1961 and the civil war of 1965.[112]

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[111]Ibid., p. 13. Fox notes that "The Export Processing Zone. . . is the ideal mechanism. Capital and expertise can be obtained from abroad quickly, start-up costs are relatively low, and rapid growth in unskilled employment can result. Free trade zones have been used in many countries including Taiwan and Korea, as an initial export tool."

[112] President Balaguer saw five successive years of 10% growth, but high commodities prices did not last. After the rise of oil prices, growth dropped to 5%, followed by President Guzman's failure to keep growth ahead of population increases and the rise of government debt. President Jorge Blanco from 1982-86 accepted the IMF reform package, but a recession followed in 1985. President Balaguer was re-elected in 1986 and growth increased to 10% in 1987. Slow progress in economic reform continues outside the zones.

PERU 1982: THE INSTITUTE FOR LIBERTY AND DEMOCRACY (ILD)

There were constraints on what A.I.D. could do in Peru in the early 1980s. Nevertheless, A.I.D. found an innovative means to improve two vital bottlenecks to economic policy reform -- the regulatory framework and the intellectual climate.[113] The A.I.D. initiative to fund the ILD began with a $36,000 grant for a conference on economic thought in 1982, and increased to $500,000 grant annually to support more than half of its budget as ILD expanded its research on the causes of poverty and its drafting of legislative proposals, with a staff that reached 50 in 1985 and 75 in 1988. The initiative brought short-term policy reform pay-offs when Peru decided to improve its regulatory treatment of poor entrepreneurs the ILD studied such as street vendors, squatters, taxi owners, and small farmers whose land was not registered. ILD also had an impact years later in the way economic reform issues were debated among Presidential candidates, and a worldwide impact as the research results were published in The Other Path.[114]

Before the initiative, Peruvian intellectuals strongly opposed economic reform and market liberalization. University-based economists were generally hostile to free market liberalization, particularly if the United States was involved. Under a leftist military regime from 1968 through 1975 and a somewhat more moderate military government from 1976 to 1980, Peru's economic polices had been unpredictable. By the 1980s, at least 12 percent of the working age population was unemployed, with 55 percent underemployed.[115] Seventy

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[113] The level of A.I.D. funding for ILD has increased since 1982, and is projected to continue for a staff of 75 at $1.8 million annually until 1995, according to A.I.D./Lima. Two recent lengthy evaluations ares "ILD Threshold Evaluation," Truitt Enterprises, Inc., March 1992, XD-ABE-159-A, and ILD: Assessment Report for the First Year of the Cooperative Agreement with U.S.A.I.D.," Ernest & Young, March 1990, PD-ABB-066.

[114] The World Bank highlighted the ILD's work in its 1987 World Development Report, President Reagan praised it in his 1987 address to the UN General Assembly, and the ILD's analysis was cited in Gabriel Roth, The Private Provision of Public Services in Developing Countries, Oxford University Press, 1987, p. 267.

[115] U.S. Department of Commerce, Foreign Economic Trends Peru, Washington D.C.: Government Printing Office, April 1989, p. 9.

percent of Peru's credit was under direct or indirect government control. Peru's excessive public spending had built up a substantial fiscal deficit. Agricultural output and exports had been stagnant. Peru was one of Latin America's poorest nations.[116] Since 1975, Peru's growth rate had been less than half of the region as a whole. In 1985 to make matters worse, Alan Garcia was elected President and refused to meet foreign debt obligations, so all multilateral donors cut off assistance.

President Garcia began to use price controls, import controls, an overvalued currency, multiple exchange rates, and other economic distortions that produced a brief boom, but ultimately resulted in a steep economic decline once foreign exchange reserves were exhausted. These distorted policies were reversed by the 1990 elections, in part because of the "consciousness raising" about economics that occurred prior to that election, assisted by A.I.D.

Eight years earlier in 1982, in the face of these adverse circumstances, A.I.D. had decided to attempt to change the intellectual climate on economic issues. The idea was to fund a scholarly research institute to investigate the sources of Peru's poverty and to publicize the results to emphasize the need for reform of Peru's economic and legal bottlenecks to growth.[117] The institute's founder was Hernando De Soto, who had sufficient credibility to initiate the economic and legal investigations with a small and youthful staff. A.I.D.' s funding was not concealed, but was not advertised either. The project proposed that DeSoto's institute would publicize its findings and even draft specific legislative for consideration by the Peruvian Congress and government.

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[116] Peru's national income may be among the most unequal in the world. A study in 1961 showed that the wealthiest 10 percent of the population had about 50 percent of the national income, while the bottom 40 percent had only 9 percent.

[117] The Institute of Liberty and Democracy has worked successfully on legislation with Peru's Congress, Supreme Court, local governments, and the media, according to "An Assessment of the ILD," Development Alternatives, Inc., November 1987, Washington, .D.C., XD-AAX-903-A, pp. 16-24. ILD has achieved worldwide recognition for its analysis and requests for technical training from 15 foreign governments, according to "Organizational Assessment and Management Plan for the ILD," Arthur Young International, August 1988, PN-ABC-088, pp. V2-V5, Appendix B.

A.I.D.'s diagnosis was correct. The publication of the results of objective investigations raised the level of debate about how to stimulate economic growth. Eight years later, there is no doubt that the Institute of Liberty and Democracy even helped to raise the level of the dialogue in the 1990 Presidential election.[118] The new President Alberto Fujimori has explicitly praised De Soto and his Institute. Perhaps equally interesting, even President Fujimori's defeated opponent adopted some of ideas promoted by the Institute, after its research results were publicly disseminated. An American observer wrote before the election of his optimism that a new government would implement economic reform: "One reason for the optimism on that score is the emergence in recent years of an authentic Peruvian movement in support of bootstrap capitalism, spearheaded by Hernando de Soto."[119]

The Institute of Liberty and Democracy was only a few people when it set up a Board of Directors in Lima, Peru in 1980, one year after a lawyer, an anthropologist and De Soto had held their first seminars in 1979. A.I.D.'s increasingly large grants from 1982 to 1986 made possible the research for its founder's 1986 book, The Other Path, which sold 40,000 copies in Peru, then was well received worldwide for its analysis of the "informal sector" in Peru. This analysis has been found relevant to many poor nations with a large unregistered and unregulated sector of the economy that in whole or in part escapes the tax collector's net, but also faces obstacles to the exercise of entrepreneurship by the sector's more dynamic members. Governments too often place obstacles in the path of this growth-oriented entrepreneurial group, and underestimate the contribution they could make to the economy.

In Peru itself, Hernando de Soto's pioneering work confronted local Marxist economists who had misconstrued the traditions of the Inca empire. They had convinced

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[118] The novelist Vargas Llosa and his coalition won the largest block of seats in both houses of Congress, and Vargas Llosa in 1990 proposed economic reforms involving fiscal austerity and privatization of state-owned enterprises, which during the 1990 election he referred to as a "shock treatment." He was specific: 1) reduce and privatize the state-owned sector, 2) abolish price subsidies, and 3) fight hyperinflation. President Fujimori had made similar promises in his election campaign: 1) to appoint a technical expert head of central bank , 2) to fight hyperinflation, 3) to raise taxes and raise public utility rates.

[119] John Williamson, The Progress of Economic Reform in Latin America, Institute for International Economics, Washington, D.C., January 1990, p. 41.

Peruvian intellectuals that Incas were socialists practicing state-owned enterprise in a communal tradition without private property or a free market. Half the Peruvian population are native Indians proud of their descent from the Incas. De Soto's widely discussed historical findings showed that Peru's Inca ancestors had practiced private enterprise and widespread trade . These findings helped to undermine the bias toward market economics that had been dominant among Peruvian intellectuals.[120]

Since the United States has been Peru's largest bilateral donor of development aid, should A.I.D. have attempted more than improving the intellectual climate? A.I.D. faced serious obstacles to a more ambitious reform effort. First, the overarching challenge A.I.D. faced in Peru in 1982 was that U.S. relations with the country had been tense for 25 years.[121] Besides poverty, anti-American hostility, and the anti-free market attitude of intellectuals, the limits of what A.I..D. could attempt to do in Peru were affected by two other problems. A.I.D. could not them wish away. One was the U.S.-Peru negotiations about the how to suppress cocaine -- 60 percent of all cocaine entering the U.S. was derived from coca grown in Peru. The other was the war with the Sendero Luminoso guerrillas, which cost the lives of 18,000 peasants from 1980 through 1990. Peru's anti-American, pro-socialist views cannot be underestimated. In light of the constraints, funding the ILD's research on the informal sector and its legislative recommendations looks in retrospect like a major success story.

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[120] Half of Peru's population of about 21 million includes are native Indians, and a quarter speak Quecha not Spanish. Many trace their descent from the Incas who ruled until the Spanish conquest around 1530. Some Indians work in the main traditional industry, mining, and others in the leading export sectors of coffee, cotton and sugar. The Indian highlands are also where, in the 1980s, coca paste, used to make cocaine, generated more foreign exchange than any legal exports.

[121] During military rule from 1968-1980, the Soviet Union became the primary supplier and trainer of the armed forces. After the 1968 coup, the military expropriated a U.S.-owned oil company as part of a nationalistic policy of "standing up" to the United States. After the armed forces turned to Moscow for supplies, in 1972 Peru became the second Latin American nation to re-establish relations with Cuba. See David S. Palmer, Peru: The Authoritarian Tradition, New York: Praeger, 1980, p. 88.

EL SALVADOR 1983-88: THE FUSADES FOUNDATION

One year after A.I.D. made its first grant in 1982 to the ILD in Peru for $36,000, it signed its first agreement in El Salvador with the Foundation for Economic and Social Development (FUSADES -- Fundacion para el Desarrollo Economica y Social) in November 1983. Once again, A.I.D. decided to sponsored research and legislative action by economic reformers themselves, while A.I.D. officials continued the classic policy dialogue with the government in power. The Foundation not only studied reform, but drafted reform legislation including a successful law to promote exports, performed training, promoted new export ideas, and supported other policy-oriented research.[122]

After the inauguration in June 1989 of Alfredo Cristiani as President, it became clear that most key members of the new economic leadership team had been associated with FUSADES, including Cristiani himself, who was one of the organization's founders and a member of its original board of directors. Others included the President of the Central Bank, the Minister of Planning, the Minister of the Presidency, and the Minister of Agriculture. The newly elected government of El Salvador began to implement the recommendations on economic reform FUSADES had been making during the previous eight years by reducing a wide range of economic distortions. The GDP growth rate, which had averaged only 1.6 percent a year during 1983-89, jumped to 3.8 percent during 1990-92.

President Cristiani and his economic team transferred foreign exchange transactions to the free market, lowered tariffs to a range of 5% to 35%, eliminated price controls on 230 items, eliminated the monopoly marketing powers of the parastatals for coffee, sugar and basic grains, reduced export taxes, simplified the tax structure and reduced maximum marginal income rates, made interest rates realistic, and reprivatized national banks. As the economy began to grow in 1990, El Salvador obtained a stand-by arrangement from the IMF, completed negotiations to enter GATT, qualified for loans from the World Bank and Inter-

[122] Development Associates, Inc., "Evaluation Report: Salvadoran Foundation for Economic and Social Development (FUSADES)," Arlington, Va., December 1988, PD-ABB-058, p. 4.

American Development Bank, and rescheduled its official debt.

Then in 1991 and 1992, President Cristiani continued the economic reforms by further reducing tariffs, reducing public sector employment, further liberalizing interest rates so they became significantly positive in real terms, closed the basic grains marketing parastatal, passed an income tax reform law, and in July 1992 approved a value-added tax (VAT) collections from which exceeded expectations.[123]

The United States had tried and failed to obtain these kinds of economic reforms during the four decades from 1946 to 1986, when U. S. provided El Salvador a total of nearly $3 billion in foreign assistance, including $1.2 billion in ESF grants, about $800 million in military assistance, and about $600 million in development assistance. During those four decades, the government of El Salvador did not establish free market economic policies.

It is impossible to trace all the linkages between FUSADES and the process of economic reform. Its success was in part due to efforts to affect public perceptions, and in part to the policy debates and proposals FUSADES stimulated. Non-economists make up the vast majority whose attitudes decide whether to change economic laws. Thus, the public and a few well-placed but poorly informed government officials may often resist or block economic reforms. A.I.D. in El Salvador anticipated this possibility, and therefore believed that published economic research and public policy dialogue could affect the intellectual climate. In fact, FUSADES had some success even before the election of Cristiani.

The foundation suggested that the highest priority research on policy reform should be studies that demonstrated the benefits that policy reforms can bring. Surprisingly few nations have had foundations like this, perhaps because many economists involved in policy reform apparently assume its benefits to be self-evident. But the benefits of reform -- and the costs of procrastination -- are not at all self-evident to those "stakeholders" who may be harmed by reforms and who may be in a position to block reform for many years.

A.I.D. and President Duarte could not really agree on a satisfactory reform package

[123] Clarence Zuvekas, Jr. "Economic Crisis and Recovery in El Salvador, 1978-1992," Staff Working Paper No. 8, Bureau for Latin America and the Caribbean, U.S. Agency for International Development, June 1993, pp. 19-22.

during Duarte's first or second terms. Duarte and the business elite were at odds, even hostile. The benefits of a limited devaluation were quickly eroded by inflation which increased in 1985 to 22% and in 1986 to 32%. Reform was slow, and A.I.D. reported in its Congressional Presentation for Fiscal Year 1989 that, ". . . A.I.D. will try in policy negotiations to encourage the government of El Salvador to put in place those structural adjustments most important for long-term growth. . . ."[124]

FUSADES grew beyond its original 1983 goals. After A.I.D. signed its first agreement with FUSADES for $185,000, mainly for activities to support the Caribbean Basin Initiative, in October 1984, A.I.D. signed another grant agreement with FUSADES to enable it to go beyond being a think tank by creating an export promotion service. FUSADES soon persuaded the government of El Salvador to enact its proposed law for promoting exports.

In August 1985 A.I.D. supported FUSADES efforts to promote non-traditional agricultural exports by introducing precision irrigation. FUSADES opened a New York office to attract investment and for export promotion. Another contract in 1985 funded a strengthening of private sector associations and additional studies by the FUSADES Department of Economic and Social Studies. FUSADES' total number of full-time employees rose to 31, and others were employed under contract.

FUSADES revised its proposal for an export promotion law, which was successfully enacted. It also drafted a law for the protection of foreign investment. After the severe earthquake of October 1986, FUSADES drafted a recovery plan and helped to administer foreign disaster relief funds. FUSADES also set up three private sector organizations to improve vocational education, to promote low-income housing, and to raise occupational safety standards.

In 1987, A.I.D. nearly doubled its funding of FUSADES to $32.5 million over several years. The export promotion programs and the non-traditional agricultural promotion continued, and FUSADES signed an agreement with A.I.D. to support the development of free trade zones. In 1989, the election of President Cristiani ended the slow pace of reform.

[124] Cited in Zuvekas, op.cit., p. 16.

JAMAICA 1983-91: THE TAX REFORM PROJECT

In the early 1980s, Jamaica began to implement reforms in response to A.I.D.'s policy advice and to cash transfers accompanied by specific written conditions.[126] Jamaica lowered tariffs, removed price controls, reduced food subsidies, and privatized a number of state-owned enterprises.[127] The results were impressive: GDP growth rate since 1988 has averaged above 3 percent, non-traditional exports have risen an average of 30 percent in the last five years, and over 100,000 jobs were added after 1985.

The heart of economic policy reform is fiscal reform: ideally, no government should have an excessive (over 5%) budget deficit. This requires both limiting expenditures and establishing a fair and efficient system of taxation to raise revenues without their becoming a drag on economic growth. Jamaica lacked such a tax system. Incomes over $3,000 faced a marginal tax rate of nearly 60 percent, plus eight additional excise taxes on consumption.

In 1983 A.I.D. financed a team of tax experts to work with the government of Jamaica for nearly a decade at a cost of nearly $5 million. A goal was to reduce tax evasion and to set up a more efficient tax collection system without increasing tax rates. The A.I.D. Project Paper stated that the experts should design a new system, draft legislation, and perform training to implement the new system. The Project Paper also made clear that "the inability of the tax structure to finance current expenditures and debt service. . . shares direct

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[126]An expanded version of this case is presented in the annex. This case is based on interviews in Jamaica conducted June 24-26, 1993 with the Chairman of the Revenue Board Edwin Tulloch-Reid and his staff, with the Secretary of the Finance Ministry, Shirley Tyndall, with the primary A.I.D. long-term consultant on the reform Matt Bourgoise, and with Betty-Ann Jones-Carr, a member and acting chairman of the committee that created the tax reform. A.I.D. economist Sam Skogstad provided overall guidance based on his role at the beginning.

[127]Jane Harrigan, "Jamaica," in Paul Mosley, Jane Harrigan, and John Toye, Aid and Power: The World Bank and Policy-Based Lending, Volume 2, Case Studies , London: Routledge, 1991, pp. 311-320.

responsibility for the present poor performance of the economy."[128] By 1986 a lower (33%), flat rate income tax was introduced which actually increased revenue. In 1991 this success for A.I.D. was expanded when a flat rate VAT was implemented, too.

This was not an easy time for Jamaica. Under Prime Minister Seaga, price controls were removed and some government enterprises were divested; but, according to A.I.D., "the quality of tax administration has deteriorated to a point where an unacceptably small proportion of the tax base is being assessed, harming economic growth."[129] There were large demonstrations in January 1985 protesting the rise of gasoline prices caused by the fall in value of the Jamaican dollar. Then the Alcoa bauxite processing facility closed in February 1985.

These incidents came after a period of steady growth in the 1960s and early 1970s followed by seven years of sustained decline that saw real per capita GDP fall by 20 percent between 1973 and 1980. Unemployment reached 27 percent in 1980 and foreign exchange reserves were exhausted. Budget deficits and inflationary financial policy brought Jamaica to near financial collapse.

To reform the tax structure without creating disincentives to economic growth, one possibility A.I.D. foresaw for Jamaica was a value-added tax (VAT). The VAT is a relatively new type of tax; no nation had such a tax in 1950. But by 1988 over 60 nations had a VAT, including almost 20 less-developed nations that had adopted it since 1984.[130]

The opposition Jamaica Labor Party won an overwhelming parliamentary majority in the 1980 elections and a mandate to deregulate the economy, stimulate the private sector and

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[128]U.S.A.I.D., Jamaica Project Paper, Revenue Board Assistance, 1983, PD-AAN-562; U.S.A.I.D., Jamaica Project Paper, Amendment No. 1, July 1986, PD-AAU-247; U.S.A.I.D., Jamaica Project Paper Revenue Board Assistance Amendment No. 2, September 1989, PD-KAT-852.

[129]T. Dwight Bunce, Evaluation of the Board of Revenue Assistance Project for U.S.A.I.D./Jamaica, March 1985, XD-AAR-463-A, attached to PD-AAR-463.

[130]Glenn P. Jenkins, "Tax Reform: Lessons Learned," in Reforming Economic Systems in Developing Countries, edited by Dwight H. Perkins and Michael Roemer, Harvard University Press, 1991.

switch to an export promotion strategy. In 1981 the new Seaga government's economic recovery program made impressive progress, and foreign investment and foreign aid increased sharply. The overall budget deficit declined from 14 percent of GDP to 12 percent. But the world market for Jamaica's principal foreign exchange earners (bauxite and alumina) contracted, as did the important tax revenues provided by these commodities.

The new government suggested that the fiscal shortfall could be offset with comprehensive tax reform. Jamaicans needed a tax reform that would not slow economic growth. Prime Minister Seaga made this question a high priority on his policy agenda. The Finance Ministry asked A.I.D. for help.

A.I.D.'s efforts to assist Jamaica with tax reform came in the context of tax reforms several years earlier in other countries, but there were some pioneering aspects to the idea as applied in Jamaica, especially in the politics of the process of designing and implementing it.

In successful tax reform, the national leader and the finance minister must play vital roles. In Jamaica, the Prime Minister assumed the job of finance minister as well. The key ingredient in A.I.D.'s success in tax reform in Jamaica was the way that the reform proposals were developed. The reform was not the result of pristine or rigid cookie-cutter recommendations delivered by a set of foreign experts. Instead, the Jamaicans who were to implement the reforms were heavily involved in the analysis and preparation of the tax proposals and the necessary legislation. A.I.D. helped them not only by providing technical expertise but also by working with them to navigate around institutional constraints. Great care was taken to present studies and analysis to key Jamaican officials over many years. 37 formal staff working papers were prepared as well as other policy memoranda.[131]

The A.I.D. team recognized that there was more than one way to design a tax system. The solutions to taxation issues had to take into account the political and administrative situation as well as the possible adjustment cost of adopting a new tax system. A.I.D. realized that, of all a nation's governmental institutions, the national tax system affects the largest

[131]Jenkins, p. 296.

share of the voters.[132]

Jamaica's tax reform in 1986 included a tax cut in the marginal tax rate on individual income tax from 58% to 33%, a cut in corporate income tax rate from 45% to 33%, and in 1991 the implementation of a value-added tax with a single tax rate. Jamaica's income tax revenue had declined in real terms from $126 million in 1978 to $110 million 1981, but it increased in part due to the tax reform.

Initially, many feared that a value added tax would be regressive and hit the poor harder than the rich. This turned out not to be true. The reason is that a large proportion of expenditures by the poor in any developing nation are for unprocessed food and items sold directly by very small enterprises. It is not feasible to collect value-added taxes on items like this that are not in the modern retail chain, so most of the expenditures by the poor are not affected by such a tax, or can be specifically exempted from VAT, as Jamaica did.

[132]Interviews in 1992 with A.I.D./Jamaica economist (in 1983) Sam Skogstad and A.I.D./Washington/PPC economist (in 1983) Paul O'Farrell.

BOLIVIA 1983: THE ECONOMIC POLICY ANALYSIS CENTER

The Bolivian Revolution of 1952, led by President Victor Paz Estenssoro, was admired and copied throughout the socialist world. President Paz nationalized most of Bolivia's mines, seized private lands in order to redistribute them to poor peasants, and formed new state-run enterprises. The national government took control of most prices. High tariffs were imposed to protect Bolivian industries. National planning and public investment were proclaimed to be the future path to prosperity.[133] These policies achieved little economic progress. A surprise came 33 years later in August 1985 when the now-78 year old and re-elected President Victor Paz announced one of the most extreme efforts at economic reform ever seen.

The Bolivian economy went into a sharp decline in the early 1980s. Per capita GDP fell by 22 percent between 1979 and 1984. Inflation accelerated and eventually reached an annual rate of 25,000 percent. Tariffs were high; most of the economy was state-controlled; and most prices were not set by the free market but rather by the government. Subsidized interest rates, artificial exchange rates and price controls distorted the economy. As the economy worsened, the military (which had ruled Bolivia for eighteen years) handed power to Hernan Siles Suazo in mid-1982. After two years of failing to cope with the crisis, Siles was abandoned by all his left-center coalition partners and was forced to call for new elections in 1885 a year ahead of schedule.

In 1982, A.I.D.'s diagnosis of the prospects for Bolivian economic reform was pessimistic. All that seemed feasible was a bold effort to try to create an Economic Policy Analysis Unit inside the Bolivian Planning Ministry that might have a chance to draft studies about what needed to be reformed.[134] Bolivia agreed in 1983 to accept an A.I.D. grant of $1.5 million to fund the new Economic Policy Analysis Unit, known as UDAPE -- Unidad de Analisis de Politicas Economicas. Normally, the Bolivian central bank would perform this

[133] Robert R. Nathan Associates, Interim Report: Bolivia Policy Reform Project, Washington, D.C., April 12, 1985, PD-AAQ-821, pp. 2-6.

[134] Management Systems International, Evaluation of UDAPE and the Policy Reform Project, May 17, 1991, PD-ABE-612, Appendix A, pp. 2-5.

analysis, but hyperinflation had driven Bolivian economists out of government service and into the high-paying private jobs or abroad. Instead, this new Unit of ten to twelve economists soon seemed to develop a monopoly on professional expertise in economic research, analysis and statistical work. The delicate matter of A.I.D. directly funding a Bolivian government unit was never an issue. One sovereign government permitted another to create and pay a unit of officials within its own bureaucratic structure. A.I.D. also funded foreign consultants to assist the Unit, including resident advisors first from Robert Nathan Associates, then after 1987 from the Harvard Institute of International Development.

Interestingly, both major Presidential candidates in the 1985 elections called on UDAPE, the Economic Policy Analysis Unit, for advice. The winner, Victor Paz, reborn at the age of 78, began to follow the Unit's advice and announced his astounding sweep of reforms: a devaluation of the peso by 93 percent, elimination of all price controls, a freeze on government salaries to cut the budget deficit, the end of interest rate controls, a sharp reduction of tariffs, and a restructuring of the state-owned enterprises that controlled mining, petroleum, and industry. These economic policy reforms received the nickname "big bang" because of their comprehensive scope and sudden implementation.

In 1986 the A.I.D. mission in Bolivia decided to amend the agreement with Bolivia and provided funds for the actual implementation of policy reform measures by the staff of UDAPE, still to be located in the Ministry of Planning.[134] In February 1986, additional studies of tax reform by UDAPE addressed the need to improve the value added tax and to eliminate inefficient taxes. These studies soon became the basis for a new tax law implemented in 1987. In February 1987, UDAPE examined the need to encourage foreign investment, stabilize the exchange rate, modernize the financial sector, and increase capital expenditures. By July of the same year, many of the study's conclusions were included in the actual decision for further reform. The resident representatives of international institutions have stated that the Unit "has the best macroeconomic system in the country, and so when a policy relies on

[134] "Project Paper, Project Number 511-0571, Bolivia Policy Reform, A.I.D., Washington, D.C., PD-AAT-838, April 24, 1986, pp. 1-5.

information, the UDAPE information system will be tapped."[135] Perhaps the best example is the accounting system of the National Treasury for which the UDAPE has developed a system to track the fiscal deficit.

UDAPE pioneered an innovative approach to soften the adverse impact the reforms could have on the rural poor. UDAPE proposed the idea of the Social Emergency Fund (FSE). The FSE delivered nearly $200 million during its 3-year "emergency" life span in nearly 2,500 projects for the poor affected adversely by the economic reforms, creating nearly 20,000 jobs a month. It is now being copied in twenty countries.[136]

Although the Bolivian economy continued to decline in 1985 and 1986, largely because of falling export prices and other exogenous factors, economic growth resumed in 1987. The GDP growth rate averaged 3.4 percent, or 0.9 percent per capita, during 1987-92. Hyperinflation was quickly stopped, and the average inflation rate of 16 percent during this period was moderate by Latin American standards. Inflation in 1992 was only 8 percent.

[135] Kenneth P. Jameson, Interim Project Evaluation: Policy Reform Project, A.I.D.-Bolivia, July 1988, PD-ABA-974, p. 53.

[136] Robert Klitgaard, Adjusting To Reality: Beyond State Versus Market in Economic Development, International Center for Economic Growth, San Francisco: ICS Press, 1991, p. 150.

HAITI 1989: STERN DIAGNOSIS FOR FUTURE REFORM

Not all governments are interested in reform. This case briefly reviews the obstacles to two reform initiatives in 1985 and 1986 in export promotion and agriculture. Perhaps the only "success" in Haiti came in a recent harsh warning about what it will take to implement economic reforms, based on the experience of A.I.D. in Haiti to date.[137] The stern diagnosis from a 1991 project on Policy and Administrative Reform states:

> The weak Haitian public sector has been riddled with corruption and has suffered from a proliferation of autonomous, overstaffed and uncoordinated ministries, agencies and bureaus, each with its own set of rules, regulations and procedures. . . .The government has never been able to effectively perform essential functions. . .The Aristide government has inherited a public sector which constitutes a major impediment to Haiti's transition to economic growth and the nurturing of democracy. Nearly all ministerial budgets go for salary costs. . . Many individuals who receive regular paychecks work few hours or not at all. No one knows how many people are actually employed by the government. . .the service delivery capacity and performance of the civil service are minimal . . . .Despite Haiti's poverty, under collection, particularly of income and property taxes from the elite, has allowed a significant portion of the national resources to go untapped. . . .75% of public employees earn less than $300 per month.[138]

The requirement to implement for reform is an alliance of politicians, bureaucrats, and technical experts. Should any side of this triangular coalition be absent, stalemate will occur.

There has been little economic policy change in Haiti from 1962 to the present, during which time U.S. economic assistance has exceeded $800 million and U.S.-influenced multilateral assistance totaled another $800 million. Whatever is wrong in Haiti, the 20-year U.S. occupation after 1915 did not produce the conditions for lasting economic growth.[139] Nor did the brutal 29-year dictatorship of Francois "Papa Doc" Duvalier after 1957. During the regime of Jean-Claude "Baby Doc" Duvalier, U.S. assistance was increased steadily from $30

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[137]Haiti Project Paper: "Policy and Administrative Reform," A.I.D./LAC 1991, Project Number 521-0222, PD-ABD-620

[138] Ibid., pp.5-6.

[139]"Haiti's Past Mortgages Its Future," Robert I. Rotberg, Foreign Affairs, Fall, 1988.

million in FY 1981 to $87 million by FY 1986, followed by a suspension of aid in early 1986 designed to accelerate the dictator's downfall, followed by an increase to $102 million for FY 1987.[140] However, after the planned elections were canceled, the U.S. suspended all non-humanitarian assistance. In 1991, $85 million was promised when President Jean-Bertrand Aristide came to power, but his overthrow on September 30, 1991 led to another round of aid suspensions. In a way, Haiti's steady "foreign aid" may only be the remittances of Haitian workers abroad to their families which reaches $200 to $300 million annually, exceeding both U.S. aid and multilateral aid. These remittances and the country's export assembly industry support much of the private sector in Haiti. Haiti has not been an easy environment for A.I.D. to practice economic policy reform.

The Haiti Export Promotion and Investment Project began in 1986 at a five year funding level of $7.7 million. Unfortunately, Haiti's exports stagnated from 1985 to 1989, then dropped sharply. Private investment decreased by 50% in 1989-91. Haiti still has the lowest per capita income in the Western Hemisphere, and unemployment combined with underemployment are estimated at 70 percent in 1991 before the U.S. embargo. An SRI International review of the A.I.D. project recommended attention shift away from export promotion to improving the business climate, government services and the quality of products Haiti produces, since further export promotion could be "counterproductive" by advertising Haiti's problems and weaknesses.[141]

Another similarly-fated project began in May 1985 when A.I.D. and the government of Haiti signed an agreement to do something about Haiti's stagnating agriculture and extreme rural poverty. A.I.D.'s intent was to require the "self-help measures" authorized under the Food for Development program. In this case, the A.I.D. mission decided to offer food aid in exchange for a written promise from the government of Haiti to implement important macro-level policy changes and institutional changes as well. The three year $45 million program

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[140] "Haiti: Prospects for Democracy and U.S. Policy Concerns," Congressional Research Service Issue Brief, January 29, 1992.

[141] Strategic Options for Haiti's Promotion of Business and Exports (PROBE) Project, SRI International, June 1991, PN-ABJ-116.

required changes in three sectors: agriculture, health, and rural roads.

The three first steps to increase agricultural productivity were to try to promote lower taxes for farmers by shifting the tax burden away from agriculture (and toward the urban-commercial sector), to expand and diversify Haiti's agricultural export portfolio, and to improve the productivity of the food production sector. The most important initiative was to try to increase coffee exports by reducing the export tax on coffee (by 25% at first). The A.I.D. agreement with Haiti had several innovative aspects.[142]

First, within 30 days of signing the agreement, the Government of Haiti was required to set up a committee to be chaired by the Minister of Planning composed of five other ministries with a Haitian Executive Secretary to be responsible for ensuring timely actions in the use of the A.I.D. funds. Haiti's first nominee to be executive secretary had to be rejected. The project needed both autonomy and a disassociation from the routine activities and budget of the Haiti ministries. It was explicitly reported in one evaluation of this project that "a lesson learned is that in order for a project to be well executed, it should be done by independent entities, not a division or service of the Ministry....with their own bank account."[143]

The results of this project five years later in Haiti were distorted beyond recognition because of larger political developments. The U.S.-led OAS embargo has caused the loss of an estimated 140,000 private sector jobs. Pesticides and fertilizers have been blocked by the embargo. Malnutrition, disease and famine are extensive in northwestern rural Haiti.[144] Foreign aid representatives are reportedly being mistreated by the new military government.[145]

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[142]Alice Morton, Negotiating and Programming Food Aid: A Review of Successes: PL 480 Title I and Title III, Case Study: Haiti, U.S. A.I.D./PVA; 1985.

[143] Harvey Sylvain, Haiti: Food for Development Program: Lessons and Recommendations, September 1986, pp. 23-25, PD-AAY-935.

[144]"Haiti: Punishing Victims," The Economist, February 8, 1992, p. 36; "Land and Health Also Erode in Haiti," New York Times, January 28, 1992, p. A3; "Embargo Translates into Ecological Disaster for Haiti," Washington Post, May 31, 1992, p. A1.

[145]"Haitian Armed Forces Repressing Aid Groups,"Washington Post, October 10, 1992, p. A17.

NICARAGUA 1991: CASH TRANSFER CONDITIONS FOR REFORM

In April 1990, when the newly elected administration of Violetta Chamorro took office, the initial attempts at reviving the badly damaged economy were not sufficient to deal with the major problems of hyperinflation, a massive fiscal deficit, and exchange rate instability. The problems were impressive. The banking system had been nationalized. Foreign trade was a government monopoly. Public employment had more than doubled since 1980 from 50,000 to over 100,000 employees. Tariff protection was set as high as 300 percent. Interest rates on savings were negative in real terms. Since 1980 the Sandinista state had progressively nationalized the economy of Nicaragua, beginning with the confiscation of the property of former dictator Antonio Somoza and his family. Some 350 state enterprises had been set up (which accounted for nearly 30 percent of the GDP) and were run by an agency called CORNAP. The disparate operations CORNAP was supposed to manage included hotels, fisheries, stores, farms, factories and coffee and sugar production.

Even before the newly elected President asked for foreign assistance, A.I.D. had met with her transition team. In fact, A.I.D. was the first international donor to lend support to the new government with both technical and financial aid.[146] A.I.D. provided the largest contribution to clearing up Nicaragua's arrears with the World Bank in order to make Nicaragua eligible for an IMF stand-by arrangement.

Unfortunately, President Chamorros's early steps in 1990 toward economic reform were not adequate. A.I.D.'s first cash transfer for $60 million was made in May 1990, the same day it was signed, without conditions, to meet emergency foreign exchange needs because the foreign exchange reserves had been spent by the outgoing regime. Nonetheless, the economic situation for the rest of 1990 showed little improvement. Hyperinflation soared to a peak rate of 13,500 percent. President Chamorro's first piecemeal efforts failed to have lasting effects because exchange rate overvaluation, excessive deficit spending and massive

[146] The A.I.D. Mission Director said, "We went from a staff of zero to 20 U.S. direct hires in eight months and obligated $265 million in six months.We had no USAID staff in Nicaragua when a worldwide cable went out asking for volunteers." Quoted in "Development Dialogue: Janet Ballantyne," Front Lines, Washington, D.C., June 1991, p. 11.

wage increases could not be controlled. By the end of 1990, in spite of the A.I.D. cash transfer, the local currency was nearly worthless. Real GDP fell by 0.6 percent, but this was improvement over the average decline of 3.6 percent in the preceding six years. The outstanding foreign debt was $10 billion, nine times the GDP, of which $4 billion was in arrears when President Chamorro was elected.

In late 1990 and in 1991 a more severe approach to policy reform was used in A.I.D.'s second and third cash transfers. A.I.D. decided to use the kind of written conditions or covenants it had successfully proposed in such countries as Costa Rica, El Salvador, and Jamaica beginning in 1982. Both A.I.D.'s second cash transfer ($118 million in December 1990) and A.I.D.'s third cash transfer ($185 million in May 1991) had specific written conditions. The targets called for reducing the fiscal deficit and the inflation rates, ending foreign trade monopolies, opening the banking sector to private enterprise, privatizing state-owned companies and reducing the public payroll. It was important that each of these targets was specific, in writing, and agreed to be feasible by the economic leaders of the Chamorro government. A.I.D. even set up specific monthly targets for fiscal and monetary performance (all of which were fulfilled). A.I.D. invited Dr. Arnold Harberger to make several visits in April and May 1991 to share his world-renowned expertise on policy reform. Dr. Harberger's writings have pointed out that in a small, open economy like Nicaragua, with imports equal to 50 percent of GDP, the exchange rate has a powerful effect on price expectations and must be kept stable to reduce inflationary expectations. Inflation must be controlled as well by limiting wage increases and controlling credit at unrealistically low interest rates. A.I.D.'s conditions focused on these issues.

The results later in 1991 were a dramatic success. The fiscal deficit became a surplus. Negative real interest rates became positive. Several thousand public employees accepted one year's cash severance pay. Many state enterprises were offered for sale to their workers and private investors. Tariffs were cut. The foreign exchange black market ended when the currency was devalued to an appropriate level.

A.I.D. had drawn successfully upon the experience it had gained in economic policy reform to help the Chamorro government transform the macroeconomic mess the Sandinistas had left behind. One evaluation report stated that "A.I.D. played a pivotal role in the development and maintenance of the Government of Nicaragua's stabilization and policy reform program."[147]

This A.I.D. success was remarkable. A skeptical critic has written:

> To its credit, the Chamorro government has slashed inflation from an estimated 15,000 percent in 1990 to about 2 percent for 1992, privatized almost 50 percent of the state-owned enterprises, and cut the number of state employees by 12 percent. Managua also boasts that it has shrunk by one-fifth its $10.8 billion foreign debt, the highest per capita debt in the world, and registered a 2 percent official economic growth rate for 1992. . . .Nicaragua signed a free trade area framework agreement with Washington in July 1991, and signed a similar pact with Costa Rica, El Salvador, Guatemala, Honduras, and Mexico in August last year.[148]

Of course, the struggle to promote economic policy reform in Nicaragua is not complete. A.I.D. is continuing to monitor the major reforms already achieved and to push ahead in other areas. The undeniable success story has been the dramatic turnaround of 1991, which used the same mix of cash transfers, specific written conditions and extensive policy advice that was pioneered earlier by A.I.D. in other nations. According to the U.S. Chamber of Commerce's Center for International Private Enterprise, the economic stabilization program "has yielded demonstrable results, including: a stable currency, the elimination of inflation, and compliance with its IMF agreement."[149]

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[147] Nathan Associates, Final Report: Evaluation of USAID/Nicaragua Economic Support and Recovery Programs I, II, III, December 1991, Arlington, Va., p. 3.

[148] Michael G. Wilson, "Restoring Democracy in Nicaragua: No U.S. Aid Without Reform," Backgrounder No. 933, The Heritage Foundation, Washington D.C., March 17, 1993, p. 11.

[149] Quoted in Michael G. Wilson, "Restoring Democracy in Nicaragua: No U.S. Aid Without Reform," Backgrounder No. 933, The Heritage Foundation, Washington D.C., March 17, 1993. Although they are beyond the jurisdiction of A.I.D., Wilson usefully points out major problems that jeopardize Nicaragua's future and were causes in June 1992 for a U.S. Congressional suspension of the remaining $104 million of the $731 million two year aid package, except for the release in December 1992 of $54 million specifically to sustain Nicaragua's economic stabilization program. The problems were retention of Sandinistas as heads of the army, courts and national police, retention of the Sandinista constitution of 1987, failure to return confiscated private property including 3,000 owned by U.S. citizens, allegations of using U.S. aid to bribe members of the National Assembly, and in December 1992 use of police to occupy the National Assembly.

One final point is interesting for those familiar with the history of A.I.D. policy reform that began in Taiwan over thirty years ago. Assistance to Nicaragua in 1991 and 1992 came from about 15 countries and perhaps 20 multilateral organizations. The total was about $725 million each year. Only one nation besides the United States provided unrestricted cash transfers in hard currency. The identity of the second nation that provided $60 million should be a matter of pride to A.I.D. veterans. In 1950, when that nation began its own economic policy reforms, its per capita GNP was about $70 dollars, lower than Nicaragua's today. Forty years later, it has one of the world's largest stocks of foreign exchange reserves. It was the first case study of A.I.D.'s reform success -- Taiwan.

COSTA RICA 1983-93: CASH TRANSFERS AND COVENANTS

A.I.D.'s role in economic policy reform in Costa Rica in the 1980s was a vigorous one.[151] A.I.D.'s success can be seen in both Costa Rica's GDP growth rate (4.2 percent annual average from 1983 to 1992) and its more dramatic average annual increase in non-traditional exports (28 percent since 1983). These growth rates represent a successful recovery from the difficulties of 1981-82. They also reflect major economic policy changes A.I.D. persuaded Costa Rican economic leaders to adopt.[152] Some critics of economic reform claim that its "austerity" can harm the poor, but in Costa Rica the improvement of household income after 1982 following the adoption of reform measures was greatest for the lowest income brackets, probably because labor-intensive businesses employing the poor benefited from increased incentives for exporting.[153]

Before the world recession and the sharp rise in oil prices in 1980-82, Costa Rica's economy had grown for two decades at an annual rate of 6.5 percent.While not impressive by

[151] An expanded version of this case study is in the annex. The case is based on interviews in Costa Rica from March 8-15, 1993 with A.I.D. Mission officials and Minister of Finance Rodolfo Mendez-Mata, Minister of Planning Vargas Pagan, Minister of Commerce Roberto Rojas, Vice President Arnoldo Lopez-Echandi, former Central Bank President (1984-1990) Eduardo Lizano, former Vice President Jorge Manuel Dengo, Presidential candidates Jose Figueres and Jose Miguel Corrales, and several professional economists and former ministers, including Thelmo Vargas and Carlos Castillo, former Planning Minister Otton Solis, former National Assembly President Rodolfo Solano, and Planning Ministry official Sylvia Saborio.

[152] The Effectiveness and Economic Development Impact of Policy-Based Cash Transfer Programs: The Case of Costa Rica, A.I.D. Evaluation Special Study No 57, November 1988, Washington, D.C. PN-AAX-210. Costa Rica is about the size of West Virginia with a population of nearly 3 million. Per capita cash transfers by A.I.D. from 1982-87 averaged $55, compared to an average per capita GDP of $1500 then.

[153] Methodological problems in such estimates are noted in Clarence Zuvekas, Jr., Costa Rica: The Effects of Structural Adjustment Measures on the Poor, 1982-1990, Staff Working Papers No. 5, June 1992, Agency for International Development, p. 1. See also Annex B, "Costa Rica: The Effects of Structural Adjustment Measures on the Poor, 1982-1990," in Program Assistance Approval Document, Trade and Investment II, Project No. 515-0260, A.I.D. Mission, Costa Rica, March 4, 1992, PD-ABD-842, p. 107.

the standards of Taiwan and Korea, this was a high growth rate by Latin American standards. However, it concealed four structural weaknesses in the Costa Rican economy that became especially important once the world economy began to change radically in 1980:

1) Costa Rica depended largely on four traditional agricultural exports of bananas, coffee, beef, and sugar;

2) Costa Rican industry was weak because it had been sheltered too long from competition behind the tariff walls of the Central American Common Market;

3) the Costa Rican private sector had been unable to develop freely because of unwise government intervention in the economy in the form of price controls, subsidies, public sector corporations, and a nationalized banking system;

4) the fiscal deficit, which averaged 13.5 percent of GNP in 1980-81 was fueling inflation and further distorting the price structure; and

5) much of Costa Rica's growth in the 1970s had been fueled by heavy borrowing from foreign commercial banks.[153]

In July Costa Rica suspended payments on its debt to commercial bank creditors. Its per capita debt by this time exceeded that of the more publicized cases of Brazil and Mexico. Per capita GDP declined during 1981-83 by a cumulative 16 percent.

From 1982 to 1988, A.I.D. made large cash transfers to Costa Rica totaling $800 million, more than the amount of loans provided by the IMF and World Bank. A.I.D. cash transfers averaged 3.8 percent of the GNP and reached as high as 5 percent.[154]

These A.I.D. cash transfers had written conditions tied to economic policy reforms. The cash transfers were paid into a separate account and not commingled with the regular budget. Each year an "ESR" (Economic Stabilization and Recovery) agreement specified the economic policy reforms to be undertaken, known as "covenants." Nearly half of the ESR

[153] Eduardo Lizano, Economic Policy Making: Lessons from Costa Rica, Occasional Papers No. 21, International Center for Economic Growth, San Francisco: ICS Press, 1991.

[154] A.I.D. Special Evaluation Study No. 57, p. xv. This study notes on p. 2 that "The Cash Transfer program is a relatively new element of the A.I.D. funding repertoire, having first reached significant levels in 1978." No history of the origins of the Cash Transfer program could be located.

covenants were aimed at the financial sector, with 33 of the 105 covenants from 1982-87 relating to the Central Bank of Costa Rica where reforms were requested to allocate more loans to private enterprise, to end rigid controls on interest rates, and to liberalize the banking system. ESR covenants also requested export promotion and privatization of inefficient government-controlled enterprises, especially covenants requiring that the state holding company, CODESA, sell its holdings in specific enterprises like a cement plant, an aluminum plant, and a sugar refinery.

Costa Rica had maintained price controls on many commodities, so covenants also required that wasteful agricultural subsidies must be cut. Additional covenants called for tariff reductions, which were to be cut in half from a 75 percent average effective rate of protection. Covenants also required that an A.I.D.-funded private sector investment promotion agency was established called CINDE, Coalition for Development Initiatives.

Costa Rica, with advice and funds from A.I.D., made a significant recovery from the crisis years of the early 1980s and gradually liberalized its economy. Indicators of income, wages, and employment have shown significant gains and income inequalities have narrowed, in spite of the fact that coffee prices are the lowest in 30 years. The fiscal deficit fell from nearly 14 percent of GDP in 1981 to only 1.6 percent by 1986, and fiscal surpluses were recorded in 1991 and 1992.

ANNEX OF EXPANDED CASES -- TAIWAN, KOREA, JAMAICA, COSTA RICA

TAIWAN 1960-65: JOINT AID INSTITUTIONS

A.I.D. obtained extremely successful results promoting economic growth on Taiwan for several reasons. The first was that the policy advice of A.I.D. fell on generally receptive ears both in the political leadership and among a few Western-trained and well-placed Chinese economists, especially after 1960. In the 1950s, however, Taiwan resisted U.S. pressure for several major reforms -- full devaluation, promoting exports, privatizing the monopoly state banking system, allowing foreign investment and reducing the state-owned half of the economy.

The second reason for success was that Taiwan permitted the creation, funding and staffing by American officials of four "joint" institutions operating outside the Taiwan government to administer an extraordinarily large economic aid program that, in the 1950s, reached as high as ten percent of Taiwan's GNP and accounted for half of all Taiwan's investment. In current American terms, this would amount to a foreign government receiving permission from the U.S. President to help spur U.S. economic growth by creating new institutions outside the federal government and spending $500 billion a year here. Obviously, the Taiwan-American relationship for economic reform was supported by President Chiang Kai-shek, who tolerated no serious political opposition and kept the military out of economic policy decisions.[155]

Before turning to Taiwan's economic circumstances and A.I.D.'s approach, it is useful to list the major actions A.I.D. supported with funds and advice on Taiwan:

1) The Taiwan dollar was repeatedly devalued in order to stimulate exports.

2) Anti-inflation measures reduced the inflation rate from 3,000 per cent in 1950 to 9 percent in the early 1950s.

3) Artificially high interest rates were fixed (briefly at 125 percent a year) to build savings.

4) A balanced or surplus government budget was maintained from 1950 to 1960.

5) All government expenditures were kept below 20 percent of GNP from 1951 to

[155]SRI International, The Taiwan Development Experience and its Relevance to Other Countries, Taipei: Kwang Hwa Publishing, 1988, p. 74.

1965.

6) High prices were set for exportable, labor-intensive products like asparagus, mushrooms, corn and sugar, but rice prices were kept low.

7) Industrial "parks" and a large export processing zone in Kaohsiung established in 1965.

8) The share of total national lending going to the private sector rose from 24 percent in 1953 to 77 percent in 1979.

9) Government loans for exporters were subsidized at one-half of market interest rates.

10) A.I.D. maintained a mission of 350 staff including consultants and Chinese employees, and a contract to support seventy economic consultants from a U.S. firm that identified economic opportunities for Taiwan in several sectors.

11) A.I.D. formed four new organizations jointly with the Taiwan government which were authorized to spend or loan U.S. aid and to propose economic activities eventually approved by the Taiwan government: the Economic Stabilization Board (in 1951), renamed the China Council for U.S. Aid (in 1958); the Joint Commission on Rural Reconstruction (JCRR); the Industrial Development and Investment Center (in 1959), which set up the first export zones in 1965; and the China Development Corporation (in 1959) which loaned to the private sector.

AMERICAN A.I.D. IN THE 1950S

In 1950, excessive inflation and the neglect of agriculture were seen by President Chiang Kai-shek and his economic advisers as the prime causes for their defeat by Mao Tse-tung. They decided to base their claim to "return to the mainland" in part on the economic success on Taiwan, after retreating there in 1949. In the 1950s, President Chiang listened both to American economic advice and to a small group of Western-trained Chinese economists who advocated applying a full package of economic policy reform to the island's economy, which had been a Japanese colony for fifty years. The five main steps were: tight controls on inflation, a balanced budget, tax reform, extremely high interest rates to attract private savings, and reform of the state-owned enterprises that accounted for half of the economy.[157]

It was not until 1960-1961, however, that A.I.D.'s most important efforts in promoting reform began on Taiwan. In an effort to overcome opposition that had been successful for years, a U.S. aid grant was offered for $40 million that was explicitly conditioned upon Taiwan adopting export-oriented policy reform measures that had been refused in 1954 when an IMF mission to Taiwan tried to promote a currency devaluation. The IMF proposal that Taiwan refused in 1954 (written by two Chinese economists widely credited later for Taiwan's success) aimed at stimulating non-traditional exports to reduce Taiwan's dependence on sugar and rice exports which then accounted for 80 percent of exports.[158]

It was significant that A.I.D.'s long-term techniques succeeded where the brief visit of the IMF team had failed. In 1960, Taiwan responded favorably to the ten American conditions, and even added nine more to them. That decision has been widely described as the beginning of the export boom that changed Taiwan's economic destiny.

THE RESULTS OF A.I.D. EFFORTS ON TAIWAN

One factor that had to be overcome was Chinese tradition favoring government enterprises over private enterprises. This pro-state bias was especially strong for senior Chinese military leaders on Taiwan who did not trust the local population of Taiwanese who would benefit most from private sector prosperity. Their perception was that the local Taiwanese majority had been influenced by their Japanese colonial masters for fifty years and did not share the

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[157] Two neoclassical interpretations are Bela Balassa, Development Strategies in Semi-Industrial Economies, Baltimore: Johns Hopkins University Press, 1982; and J. Fei, Gustav Ranis, and Shirley Kuo, Growth With Equity, The Taiwan Case, New York: Oxford University Press, 1979. Two studies which stress government intervention as the cause of Taiwan's growth are Stephan Haggard, Pathways From the Periphery: the Politics of Growth in the Newly Industrializing Countries, Ithaca, N.Y.: Cornell University Press, 1990, pp. 76-99; and Stephen C. Smith, Industrial Policy in Developing Countries: Reconsidering the Real Sources of Export Led Growth, Washington, D.C.: Economic Policy Institute, 1991.

[158] S.C. Tsiang, "Taiwan's Economic Miracle: Lessons in Economic Development," in World Economic Growth, edited by Arnold C. Harberger, San Francisco: ICS Press, 1983, p. 306). Tsiang was one of the two Chinese economists credited by Harberger for Taiwan's reforms.

fierce ideological dedication of Chiang Kai-shek's mainlanders, who saw Taiwan mainly as a base to use to re-conquer mainland China.

A book length study concluded on the basis of extensive interviews on Taiwan:

> By far the most important consequence of U.S. influence was the creation in Taiwan of a booming private enterprise system. Without the intervention of A.I.D., private enterprise would not have become, by 1965, the mainspring in Taiwan's economy. A.I.D. made the private sector flower both by financing projects that created external economies for the private investor, and by putting steady pressure on the Chinese government to improve the climate for private investment.[159]

A.I.D.'s successful role was also confirmed by Taiwan's Minister of Economic Affairs in a 1961 article. He stated Taiwan (and China) lacked experience with private enterprise, with corporate business, and with modern commercial practices. The three remedies for this lack of experience were the creation (with U.S. funds) of the China Development Corporation, the Industrial Development and Investment Center, and the export processing zones in Kaohsiung which were such a success that plans were made to set up similar zones all over Taiwan. The Minister credits A.I.D. in these words:

> U.S. aid played an important role in the development of private industry, not only because it has served as a major source of investment funds, but because it has encouraged and helped induce the flow of private capital into the channels of production.[160]

Annual per capita income in Taiwan rose from about $70 in the late 1940s to over $2,000 by 1980. During this period, real GNP grew annually at an average of 9.2 percent: 8.2 percent in the 1950s, 9.4 percent in the 1960s and 9.9 percent in the 1970s. Real GNP in 1980 was eleven times real GNP in 1952. By contrast, while Taiwan was a Japanese colony, its growth rate had been less than half this rate, about 4 percent.

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[159]Neil Jacoby, U.S. Aid to Taiwan, A Study of Foreign Aid, Self-Help, and Development, New York: Praeger, 1966, p. 138..

[160]Cited in Neil Jacoby, U.S. Aid to Taiwan, A Study of Foreign Aid, Self-Help, and Development, New York: Praeger, 1966. This book was based on Jacoby's lengthy evaluation for A.I.D. with a preface signed by David Bell that states it is the first major evaluation of an A.I.D. program.

During the fifteen years 1951-65, a total of $1.5 billion of American aid was spent on Taiwan, an average of almost $100 million a year in then-year dollars. Taiwan's population grew from 8 million people in 1951 to 13 million in 1965, and its GNP grew from $900 million to $2.4 billion by the time Taiwan "graduated" from A.I.D. in 1965. From 1952 to 1962, nearly half of the investment in Taiwan was financed by U.S. government aid. Almost no private foreign capital flowed into Taiwan before 1961. There were also substantial "multiplier effects" to U.S. aid because of the economic policy reforms Taiwan agreed to implement under pressure from the A.I.D. advisers. By one calculation, without the impact of U.S. economic aid, the level of per capita GNP of 1965 would not have been achieved until 1995.[161]

Ironically, A.I.D. influence on Taiwan's polices may have been the inverse of its funding level. U.S. aid reached a high of ten percent of Taiwan's GNP in 1951, eventually falling to two percent of a greatly increased GNP by 1965. Overall, from 1951 to 1964, economic aid was equivalent to 34% of total gross investment in the Taiwan economy.

Half of the U.S. aid was called "Defense Support" (today called ESF) and a fourth was PL 480 agricultural surplus. Actual "development aid" in projects (technical assistance of $36 million and development loans and grants of $165 million) made up only 12 per cent of the fifteen year total of U.S. aid. In other words, most U.S. aid was not in development projects. Very little was aimed at industry. Most went to agriculture and infrastructure .

Free market enthusiasts will be disappointed to learn that about 80 percent of all U.S. capital assistance went into Taiwan's public sector. Only one fifth directly aided the private sector. U.S. aid was concentrated on government-owned operations in electric power, transportation, communications, fertilizer, chemical and agricultural industries, all operated by the government. U.S. aid financed more than one half of the domestic investment in the public sector and less than one eighth of the investment in the private sector.

In 1950, interest rate policy was innovative, not a free market policy. To boost savings and fight inflation, the government offered special preferential savings accounts that paid 125 percent per year. This eight-year-long policy was effective. Seven per cent of the money

[161]Jacoby, p. 152.

supply was deposited within eight months. Even after the government sharply reduced its the subsidized interest rate (and inflation dropped sharply), these savings deposits grew to 44 percent of the money supply. By 1958, when this program ended, it had attracted almost 30 percent of the money supply. The government's central bank had use of these funds for investment in the island's infrastructure.

Taiwan used U. S. aid to balance its budget from 1950 to 1960, but also followed U.S. advice to hold government expenditures low as a percent of GNP; the actual range was from 17 to 20 percent.

Rice was Taiwan's main agricultural product and textiles were the major imports. The government bought most rice at low prices to discourage domestic production beyond the level needed for self-sufficiency, but guaranteed higher prices for other agricultural products (sugar cane, asparagus, mushrooms, and corn) in a successful effort to stimulate production of more valuable products.

After this first decade, Taiwan in the 1960s ended its policy of import substitution and decided to promote exports and to attract foreign investment which heretofore had been nonexistent. A Statute for Encouragement of Investment, with a few incentives for exports, produced only a slow response in the early 1960s. In the 1965, the statute was revised . The Kaohsiung Export Processing Zone was set up, within which no duties were imposed on imports. Tariff protection was also reduced by roughly one-half from 1961 to 1971.

A vital source of funds was provided by redirection of bank credit.The government increased the share of total lending to private enterprises from 24 percent in 1953 to 77 percent in 1979. The share of exports in GNP increased from 9 percent in 1952 to 49 percent in 1980. Taiwan had a trade deficit in the 1950s ranging from 6 percent of GNP to as high as 10 percent. U.S. in the 1950s aid financed more than 40 percent a year of Taiwan's imports; by 1965 when U.S. aid was terminated, the figure had fallen to only about 10 percent. Within the export boom, the composition of exports changed dramatically. Agricultural products decreased from 92 percent of total exports in 1952 (mainly rice and sugar) to 9 percent in 1979, while the share of industrial products increased from 8 percent to 91 percent.

The total personnel of the aid mission in Taiwan averaged about 350 people including consultants, contractors and Chinese personnel. At the same time, until 1962, U.S. funds financed a contract between the Taiwan government and the J.G. White Engineering Corporation of New York. The aid mission relied on the technical and economic studies and on the U.S. experts that the contract with J.G. White brought to Taiwan to advise on the sugar, power, railroad, construction, chemical and other industries. Seventy two Americans made up the J.G. White technical staff. They identified investment opportunities and presented economic evaluations to the A.I.D. mission and to the Taiwan government.

Two positive steps were linked. The United States created institutions outside of the Taiwan government to administer aid, and there was an unusual continuity of these institutions and their Chinese personnel. When aid operations began in early 1950, American officials determined what to buy (mainly shoes, clothing and food) and then purchased and shipped these items. The Taiwan government simply distributed them. Then, in March 1951, the United States suggested that the Minister of Finance head an "Economic Stabilization Board" to coordinate policies across ministries for trade and all economic policy. The justification for this super-ministerial unit was to fight the 3,000 percent hyperinflation. American aid officials not only attended meetings of the board but were actively involved in its work, without official membership.

It was important to A.I.D.'s success on Taiwan that American aid funds were administered outside the regular ministries and outside the government's regular budget. Through this unusual Board, all U.S. economic aid inputs could be coordinated closely with the Taiwan government's economic polices to control inflation and to direct public and private investment. The Board had several subcommittees in which U.S. aid officials participated by advising on decisions about monetary policy and foreign exchange policy.

The Board was re-named in 1958 as the China Council on U.S. Aid (CUSA), and continued to operate in a semi-autonomous manner outside of the ministries. Not subject to Taiwan 's civil service salary limits, the Council could recruit talented staff at high salaries. Over ten years the Council, like the Economic Stabilization Board, developed a cumulative gain in expertise. It coordinated polices across ministries and provided new ideas in long-range economic planning and other technical studies. Many have observed that if U.S. aid had been part of the Chinese government's budget, and administered through the regular departments of government, its developmental effects would have been greatly diminished.[162]

The second unusual institution for administering U.S. aid on Taiwan was the JCRR, the Joint Commission on Rural Reconstruction. It had three Chinese and two American commissioners appointed by the presidents of the two countries. It served not only as the agricultural division of the U.S. A.I.D. mission in Taiwan but also as the de facto agricultural ministry of Taiwan. This unit also functioned outside the Taiwan government's regular bureaucracy, and could recruit and maintain a highly skilled and highly paid staff for two decades.[163]

The source of influence of the economic advice of the JCRR came from the fact that, between 1953 and 1964, it provided about 40 percent of the budget of Taiwan's agricultural ministry. It advised and monitored extensive land reforms from 1949-53. It worked with (and built up) farmers' associations to improve rural health, and brought in new technology for water resources, livestock, forestry, and fishing. An A.I.D. memorandum in 1964 recommended that the JCRR be used in other developing nations.[164] The authors of this document wrote that the economic development of rural Taiwan was due "mainly" to the JCRR's success, to the JCRR's semi-autonomous nature, and its policy of using local organizations as project sponsors.

A.I.D. used its own funds to set up two other units that had important impacts on economic growth. A.I.D. and the Taiwan government in 1959 established an Industrial Development and Investment Center to facilitate foreign investment. Its offices in New York and Rotterdam were able to cut red tape, provide legal and investment advice, and assist foreign investors with visas, site visits, and finding loans, in order to develop industrial parks

[162]SRI International, The Taiwan Development Experience and its Relevance to Other Countries, Taipei: Kwang Hwa Publishing, 1988, pp. 64-69.

[163]Dennis Fred Simon, "U.S. Assistance, Land Reform, and Taiwan's Political Economy, " in Edwin Winckler and Susan Greenhalgh, eds., Contending Approaches to the Political Economy of Taiwan, Armonk, N.Y.: M.E. Sharpe, 1988.

[164] See John T. Montgomery, Rufus B. Hughes, and Raymond W. Davis, Rural Improvement and Political Development: The JCRR Model, A.I.D., Washington, D.C., June 14, 1964.

throughout Taiwan. In 1961, it set up one of the world's first tax-free and duty-free export processing zones near a northern Taiwan town called Keelung. This was a success which soon resulted in another, larger zone being set up in the southern port of Kaohsiung in 1965.

Besides the new institutions of JCRR, the Economic Stabilization Board, the China Council for U.S. Aid, and the Industrial Development and Investment Center, A.I.D. in Taiwan pioneered by using aid funds to establish the China Development Corporation (CDC) in 1959. The CDC board members were both government officials and private businessmen, and CDC could invest in equity securities. It obtained loans from the World Bank in 1962, and by 1965 had invested in 250 business firms. The CDC filled a vacuum because Taiwan's commercial banks during this period were controlled and could not make loans to businesses or purchase equity shares.

A.I.D. provided a variety of economic advice to Taiwan's leaders. It was significant that President Chiang Kai-shek had analyzed the causes of his defeat by Mao Tse-tung to be in part poor economic policy, especially hyperinflation. Chiang Kai-shek also announced that his plan to recover the mainland would depend both on building up Taiwan's economy as a "base" and also as a "showcase" for the economic benefits that his government would offer to the mainland Chinese after recovery of the mainland. Given this commitment of the nearly dictatorial leader of Taiwan, and his dependence on the United States to provide both the military and foreign aid components he would need, the economic advice offered by the U.S. experts could hardly be ignored.

Nevertheless, Chinese economic tradition seems to have favored government enterprises over private enterprises. Nor was private foreign investment welcomed from Japan or elsewhere prior to the early 1960s. Professor Jacoby concluded on the basis of extensive interviews: "By far the most important consequence of U.S. influence was the creation in Taiwan of a booming private enterprise system. Without the intervention of A.I.D., private enterprise would not have become, by 1965, the mainspring in Taiwan's economy. A.I.D. made the private sector flower both by financing projects that created external economies for the private investor, and by putting steady pressure on the Chinese government to improve the climate for private investment."[165]

Taiwan's Minister of Economic Affairs wrote frankly in 1961 in an article on the growth of private industry in China that Taiwan (and China) lacked experience with private enterprise, with corporate business and modern commercial practice. The remedy for this lack of experience was the creation (with U.S. funds) of the China Development Corporation, the Industrial Development and Investment Center, and the export processing zone in Kaohsiung which was such a success that plans were made to set up similar zones all over Taiwan.

In his article in 1961, the Minister credits A.I.D.: "U.S. aid played an important role in the development of private industry, not only because it has served as a major source of investment funds, but because it has encouraged and helped induce the flow of private capital into the channels of production."[166]

During the fifteen years Taiwan received U.S. aid, the large A.I.D. office had to continually press Taiwan to expand its exports, to maintain realistic foreign exchange rates, to raise the cost of railroad and electric power rates to cover full costs, and to improve the environment for private and foreign investment. By 1963, A.I.D.-financed trade missions were dispatched to Latin America and Africa, and A.I.D.-financed technical assistance was provided to improve the quality of Taiwan's export products.

It is worth examining briefly how the A.I.D. role in Taiwan differed from that in Korea, where A.I.D. did not succeed as early as in Taiwan, even though U.S. aid on a per capita basis was higher in Korea, and Korea had a lower rate of population growth than Taiwan. Korea's GNP growth per capita (1.9%) was slower from 1953 to 1963, only half of Taiwan's rate (3.8%).

Six differences may help explain Korea's slower performance:

1) ill-fated efforts of A.I.D. in 1950s to industrialize Korea behind tariff barriers;

2) Korea's political instability, unlike Taiwan's stable, one-party authoritarian rule;

3) the continuing inflation in Korea caused by the Korean civil war;

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[165]Jacoby, p. 138.

[166] Jacoby, p. 24.

4) Korean planners support for import substitution, not export promotion;
5) Korea's cold climate, which was less favorable to agriculture than the climate of Taiwan where adequate rainfall and semitropical temperatures permitted one of the highest outputs per acre in the world;
6) the very extensive war damage in South Korea due to ground combat and bombing;
7) Korean acceptance of U.S. economic advice only after a military coup and the appointment of new Korean economic officials who allied themselves to A.I.D.

KOREA 1964-65: THE EXPORT PROMOTION PROGRAM

This case study describes eleven actions A.I.D. carried out in 1964 and 1965 that contributed to the remarkable reversal in South Korea's economic development strategy. In the 1950s, Korea had refused to accept U.S. economic advice to promote exports. What did A.I.D. do differently to get these results in 1964? What were the results?

By 1980, when Korea became one of the few nations ever to "graduate" from the U.S. foreign aid program, Korean annual trade grew from about $400 million in the early 1960s to over $150 billion, due to its own efforts and to the openness to Korean products of the U.S. economy in the 1960s and 1970s. These results are all the more dramatic because of the devastation of the Korean war in the early 1950s, which left Korea with a per capita income of about $70, one of world's poorest nations, and on a par with India and Pakistan. Today, Korea is the sixth largest export market for the United States and the fourth largest importer of U.S. farm products. Korea has become an aid donor to over 90 nations.

Most accounts of Korea's economic success play down the role of A.I.D. Yet Korea's growth is widely agreed to be due to its export surge, which began when Korea adopted a new strategy in 1964 which brought about "perhaps the most dramatic and vivid change that has come about in any developing country since World War II."[167]

Some national policy reform in the 1980s has required conditional cash transfers by A.I.D. that "buy" policy change. This was not the path in Korea. Inflation remained high in the 1950s, trade barriers were high, and the currency was overvalued. In fact, Korea had refused to accept much American economic policy advice from 1948 to 1963, during which time U.S. aid reached a peak of more than ten percent of Korea's GNP and actually exceeded total domestic savings in several years. In 1948, Korea would not implement reforms that were eventually implemented in 1964. The U.S. had no like-minded allies inside the Korean government, and it had to back down.. One American adviser at the time said, "More than once--over the essentiality of a Republic of Korea anti-inflationary policy, or the pricing of

[167] Anne O. Krueger, Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences, New York: National Bureau of Economic Research, 1977, p. 82; Anne O. Krueger, The Developmental Role of the Foreign Sector and Aid, Cambridge, Mass.: Harvard University Press, 1977.

aid goods to be sold on local markets or the underwriting of a non-essential public investment project--we have backed down from 'firm' positions."[168]

KOREAN POLICIES BEFORE THE 1964 EXPORT PROMOTION REFORM

Korea had some export success in the agricultural sector during 37 years of Japanese colonialism that ended sharply in 1945 when, after the American decision to divide Korea, the North Korean and later Chinese invasion destroyed the industrial and much of the agricultural base of South Korea. After 1953, South Korea feared it could not survive on agriculture alone (most industry and minerals were in North Korea), so President Rhee resisted American advice to stress exports and agricultural investment. He successfully pushed industrial growth to an average of 11% a year in the 1950s, but at a high cost. Korea's annual GNP growth averaged only 3.9 percent from 1953 to 1962, falling to 2.3 percent in Rhee's last year as President, as he tolerated high inflation, budget deficits, and an overvalued exchange rate that provided no incentive to export.[169] Rhee refused the advice not only of the U.S. aid mission, but of his own economists in "enclaves" in the national bank and the Finance Ministry.

Rhee's policies made sense in one respect because they did benefit his political supporters, especially those who owned industries protected behind a wall of high tariffs and an overvalued exchange rate. His cronies could profit from speculation. Nevertheless, the Eisenhower administration decided not to use its leverage and chose to tolerate Rhee's policies because of Korea's strategic importance, in spite of reports that in Korea "usury only begins at 15% at month and most investments are absurdly speculative by Western standards. . . .The question of what happens if all foreign aid is withdrawn tomorrow still boils down only to how many days it would take for complete collapse."[170]

President Rhee's policies kept Korean exports and overall growth at a very low level,

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[168] John P. Lewis, Reconstruction and Development in Korea, Washington, D.C.: National Planning Association, 1955, p. 44

[169] GAO Report: Examination of Economic and Technical Assistance Program for Korea, FY 1957-1961, September 1962, PN-ABK-821.

[170] N.C. Beck, This is Industry in Korea, August 1964, PN-ABK-582, p. 1.

in spite of Korea's export experience as a Japanese colony. Under Rhee, one fourth of Korean "exports" were actually local purchases by the U.S. Army. The rest were mostly raw materials such as tungsten, clay, coal and silk yarn. Rhee's inflationary economy had made production for the international market far less attractive to business than the large profits that could be made in land speculating, construction of factories, and importing raw materials for re-sale. Beer and cigarettes for Japan and U.S. troops were the second and third ranking industrial products after low quality textiles.

A.I.D.ADVICE TAKES ROOT

When American economic advice was finally accepted in 1964, one crucial difference was the commitment of the Kennedy Administration which agreed that the A.I.D. mission director could suspend food aid in 1962 even after two bad harvests had placed Korea in a difficult position.. A second factor in 1964 was General Park Chung Hee, the newly elected Korean President whose legitimacy, after his illegal military coup, depended on keeping his election promise to correct the economic errors of the civilian government he had overthrown. A third factor may have been the dynamism and creativity of the A.I.D. employee who ran the program its first two years, judging by his book.[171]

Among the aspects of A.I.D.'s policy reforms in Korea, the most important was the export promotion project. According to Amicus Most who ran it, there were only "casual and uncoordinated relations" among the Korean government agencies responsible for foreign trade and the Korean private sector. There was no "overall programmatic and policy approach" to exports.[172] There were no branches of foreign banks in Korea. The world was unfamiliar with Korean products, as might be expected for a nation known for centuries to its neighbors as the "Hermit Kingdom." As difficult as it may be to imagine today 30 years later, Most reported that "Korean businessmen had little or no contact with the outside world. . . .and the

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[171]Amicus Most, Expanding Exports: A Case Study of the Korean Experience, Washington, D.C.: U.S.A.I.D., 1969.

[172]Amicus Most, A.I.D. History of Exports 1964-1966, Seoul, 1964-66, October 1966, PIO/T 490-13-230-606-3-40101.

rest of the world had little knowledge of or faith in Korean products."

Before reviewing eleven major export promotion actions that A.I.D. carried out, it is useful to recall that A.I.D. had vital allies inside the Korean government who welcomed A.I.D. pressure and even conditions on aid.[173] An A.I.D. study of the use of conditional loans to influence policy found that Korean officials, especially in the Finance Ministry, used the conditions in foreign aid loans in the 1960s to provide "an excuse for the unpopular policies they wanted to carry through anyway."[174] What were these unpopular policies? The backdrop to the export promotion drive that A.I.D. assisted was that the exchange rate was made more realistic under an IMF stand-by agreement, a tight money policy was implemented to cut the high inflation of 1963, taxes were increased, and domestic interest rates were increased, all according to A.I.D. advice. Then came the export drive.[175]

A.I.D. RESPONSE TO PRESIDENT PARK'S REQUEST FOR EXPORT HELP

Two years after the military coup of 1962, and in part because of a growing trade deficit that reached $229 million in 1963, the Korean military government decided to give a very high priority to export development. President Park Chung Hee publicly announced this high priority and instituted a monthly meeting at the Blue House at which he personally received the latest report on the export promotion program and made decisions on the spot to resolve export problems.

Before this decision to promote exports, however, President Park and the U.S. government had gone through a stormy period during the first two years after his military coup. Park and fellow officers distrusted economic experts. Park was aware that in the 1950s President Rhee's bureaucrats allocated foreign exchange, bank credits and import licenses to

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[173]David Cole and Princeton Lyman, Korean Development: The Interplay of Politics and Economics, Cambridge, Mass.: Harvard University Press, 1971.

[174]Elizabeth Carter, The Use of Program Loans to Influence Policy: Korea , PPC/Evaluation Staff, March 1970, PN-AAQ-813, p. 210.

[175]Vaughn Mechau, Economic Assistance to Korea and A.I.D. Accomplishments 1954-1960, 1961, PN-ABK-610; Robert R. Nathan Associates, Report of Audit- Economic Planning Board Project, A.I.D. Seoul, September 1966, PD-AAF-868-A1.

benefit their cronies in the private sector. Park and his military advisers enforced a new law against "illicit wealth accumulation" that terrorized businessmen. Park nationalized all the commercial banks. He ordered the Finance Ministry to take control of the central bank, monetary policy and credit allocation. He did not seek or heed American economic advice for the first two years of his rule. The U.S.-Korean Economic Coordination Commission did not meet from 1961-1963.[176]

None of this created an easy environment for the A.I.D. mission in Seoul. Thus, in 1964, Park's decision to start the export promotion drive was seen as a new channel for A.I.D. staff to influence Korea's future economic policy. In a decision that was crucial to the success of the export program, the A.I.D. mission in Seoul quickly decided to become an intimate part of the Korean governmental effort. In March 1964, the formal request for assistance came from a sub-cabinet official, the Assistant Minister for Commerce, but the A.I.D. mission director decided to give it the highest priority. He was not distracted that month by the national riots against Park Chung Hee's efforts to normalize relations with Japan and the imposition of martial law.

Within the A.I.D. mission, an Export Committee was formed with most A.I.D. elements represented. There was a great deal of personal participation by the A.I.D. Mission Director and Deputy Director. The A.I.D. mission agreed with the Korean authorities that although exports had been as low as $32 million in 1960, a target of an $250 million could be set for 1966.

The A.I.D. mission's approach was breathtaking in its comprehensiveness. The first two steps were the drafting of an overall export promotion program and the creation of new institutional arrangements. The Korean economy was already under close management by a Presidential super-ministry called the Economic Planning Committee. Its associated Economic Cooperation Council also had the personal attention of President Park. A new "Export Promotion Sub Committee" (EPSC) was created in March 1964. Surprisingly, in light of many nations' concerns for sovereignty and desires that donors must stay in their proper place,

[176] David I. Steinberg, Foreign Aid and the Development of the Republic of Korea: The Effectiveness of Concessional Assistance, December 1985, PN-AAL-075, p. 29.

A.I.D. staff became members of the Export Subcommittee. In fact, the A.I.D. deputy mission director co-chaired it.

What was more important was the decision to form a "steering committee" of the subcommittee to be co-chaired by a Korean Assistant Minister of Commerce and Mr. Amicus Most, the mission expert on exports. What made this arrangement so effective was that the steering committee set up a series of working groups. The rank and membership of the steering committee was also important. It included several vice ministers from other ministries, high level representatives of Korea's main banks, the President of the Korean export promotion agency (KOTRA), and from the private sector the heads of the four main business organizations.[177]

This was a unique combination of Korean private and governmental representatives who participated along with A.I.D. officials and consultants in a series of studies to diagnose what had to be done to implement President Park's call to promote exports. All these groups knew the President and his Blue House staff would be waiting for the monthly progress report. A bold set of institutional arrangements mixed together not only leaders from the Korean public and private sectors, but also A.I.D. officials in the large set of working groups. The A.I.D. input made a difference in determining whether these arrangements went beyond mere hollow administrative forms.

A.I.D. input to the three-part steering committee was made difficult by the inexperience of the Korean government officials. The 1961 military coup had removed from office so many officials that most of the new staff was, according to an A.I.D. report, "young, new and inexperienced, and very few of them had any actual business or trade experience." Even before the 1961 coup, of course, the Korean civilian administration had operated as employees of a colony owned by Japan, and had suffered the losses of World War II and the 1950 invasion by North Korea. Korean businesspeople also faced enormous problems. Foreign travel was tightly restricted, as was foreign exchange. Few foreign buyers visited Korea. The total number of foreign tourists in 1964 was about 1,000.

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[177]Jerome I. Udell, Report on KOTRA , September 1965 PN-ABK-586.

ELEVEN A.I.D. ACTIONS TO REFORM KOREAN EXPORT POLICY

Before describing the background to the decision, it is useful to understand in detail what A.I.D. actually did to facilitate reform of Korea's export policies:

1. A "campaign" of personal contacts by the A.I.D. mission staff explained to organizations of private sector entrepreneurs why they should now focus on exports instead of land speculation and construction. A.I.D. briefings explained the economic significance of the decision to establish a floating exchange rate n March 1964.

2. The joint A.I.D., public and private members of an "Export Promotion Steering Committee" met to propose immediate solutions to the most important obstacles discovered by its members. A feedback loop had been set up because unresolved issues were reported each month to the President of Korea, who decided personally how to resolve them, displaying his intense commitment to export promotion, and to following A.I.D.'s work and advice on the subject.

3. The Committee decided to skip over the bad Japanese export phase (from 1945 to 1950) when low-quality, very cheap goods were exported, because Japan needed many years to overcome a reputation for shoddy goods. Therefore, five steps were quickly taken:

a. A.I.D. brought in four consultants to work at the Korean Productivity Center.

b. The Korean National Industrial Research Institute, which was the government agency responsible for quality testing, was largely equipped with A.I.D. funds.

c. It was decided to set up an export inspection service and to require a government quality control certificate for certain commodities prior to export.

d. A.I.D. funded an advisor appointed to the export laboratory.

e. A.I.D. funded consultants to study quality control, the men's apparel industry, marketing, handicrafts, and to develop new ideas for agricultural exports such as canned and preserved fruits, vegetables and seafood.

4. A.I.D. set up export promotion programs in regional centers outside of Seoul. For example, in the fourth largest industrial city of Taegu, A.I.D. sent six consultants to improve productivity and quality control at the factory level. The city government contributed to a new building for an expanded laboratory for which A.I.D. funded the equipment. A.I.D. worked directly with city officials and sixteen leading industrialists, who formed an association and

established their own productivity center.[178]

5. A.I.D. funded teams of Koreans from specific industries to visit nearby countries to study export promotion methods. Teams in quality control, the garment industry, handicrafts, and ceramics were sent to Japan, Taiwan and Hong Kong. Four Koreans were funded to attend the annual International Marketing Institute seminar in Massachusetts and other U.S. cities. All these teams prepared reports upon their return to pass on to others.

6. The A.I.D. mission prepared three studies to identify the sources of delay in the procedures and paperwork involved in exporting and foreign travel for businessmen. The Export Promotion Sub-committee even set up a "Procedures Committee" to reduce the amount of time required for exporting. A.I.D. was requested to supply a outside consultant for this work, too.

7. Legislation was drafted and quickly passed by March 1966 to set up an arbitration system to handle claims arising between foreign and Korean businessmen. A.I.D. supplied a consultant to work with the Korean Chamber of Commerce to establish the first Commercial Arbitration Association.

8. The Export Promotion Sub-committee recommended establishment of an export insurance system, and A.I.D. agreed to provide a consultant to assist in setting it up.

9. The A.I.D. mission persuaded the U.S. Defense Department to send a team from Washington to explore the prospects for increasing the quality of Korean products that the U.S. armed forces in Korea were purchasing. U.S. forces in Korea were purchasing many items from Japan and had never permitted Koreans to bid on them. Only about $35 million worth of purchases were made in Korea. As a result of this effort, these purchases doubled. The U.S. Army also worked with Korean companies to raise their quality standards so that the U.S. could purchase rubber tires, auto batteries, shrimp and many other products that the Koreans could now export as well. A.I.D. seems to have assisted also in facilitating increased Korean sales to the U.S. armed forces in Vietnam, nearly doubling Korean exports of services

[178]Inspection of Export Products in Korea, 1964 PN-ABK-581;Technical Assistance Project History and Analysis Report, A.I.D. Seoul, November 1964, PD-AAD-422-G1; Procedures Required for Export in Korea, December 1964, A.I.D. Seoul PN-ABK-617.

and products sold to support U.S. forces in Vietnam to about $50 million in 1966.

10. A.I.D. facilitated rapid growth of a new service export that generated millions of dollars and yen. The Korean tourist industry soon grew from a mere 1,000 tourists a year to become the second largest source of foreign exchange. The A.I.D. mission hired an American expert to diagnose the problems and prepare a master plan. In 1964 Korea lacked even one deluxe tourist hotel. Museums, cultural sites, restaurant menus for foreigners, and tourist shopping facilities all had to be developed. Japanese tourists would be the best early market.

To promote tourism, A.I.D. had to work through the Ministry of Transportation because it directed the Korean Tourist Service, which in turn owned and operated the few tourist hotels. A.I.D. learned that a crucial obstacle was that Korea was not a "free stop" under the rules of the International Air Transport Association. Early in 1965, A.I.D. mission staff met with the leading wholesale ticket agents of the Pacific Air Transport Association who agreed to pass a resolution at their convention so Korea could receive stopover tourists along the route between Japan and Hong Kong.

A.I.D. mission staff went even further to promote tourism to Korea by writing to the three leading U.S. hotel chains (Hilton, Intercontinental and Sheraton) and then accompanying the head of the Korean overseas trade agency to the United States to visit the headquarters of each hotel chain, who agreed after the meetings to send representatives to Korea.

11. A.I.D.'s direct action included identifying foreign buyers of Korean exports. A product-by-product marketing survey resulted in the naming of 35 "product chiefs" appointed by the Commerce Ministry and the Foreign Ministry. Each of the 35 "chiefs" was required to submit reports to his working group of the Export Promotion Steering Committee, each of which had an A.I.D. technical advisor. American department store chains were identified in A.I.D. studies to be good export markets. So, in October 1965, the A.I.D. mission's export expert accompanied his fellow steering committee member (and the head of the Korean overseas trade promotion agency) to the United States where they successfully persuaded senior representatives of Macy's, J.C. Penney, W.C. Grant, Sears Roebuck, Montgomery Ward, the May Company, Allied Stores and Woolworth to travel to Korea, together. After that trip, many stores opened purchasing offices in Korea.

In conclusion, the success of this case can best be understood in terms of the way that

institutional arrangements energized a Presidential decision. It may have been necessary but not sufficient to have the President of the country interested in the export drive. The key was to bring the expertise of the A.I.D. mission staff to bear on the Presidential commitment in order that it could be implemented. It was probably vital that A.I.D. staff were given essentially co-equal status on the newly created and unusual public-private steering committee which could set up additional working groups with the participation of additional A.I.D. experts. Some of idea of the intimate role of A.I.D. comes from the fact that A.I.D. officials not only co-chaired and actually took the official minutes of these governmental committee meetings, but A.I.D. staff even set the agenda for the meetings, subject to the approval of the Vice Minister of Commerce.

This institutional arrangement permitted many creative ideas of the A.I.D. mission to be aimed at a wide array of obstacles to increasing exports. A.I.D. experts and consultants did not just diagnose problems, however. They were able to be part of the solution because of the institutional power of the steering committee and the monthly reports due to the Blue House. The A.I.D. export promotion advisor pointed out in his report in 1966 that much of the program's success was due to the requirement that he and his Korean counterparts had to prepare an annual master plan for the following year's export promotion program in which they could incorporate their diagnosis and prescriptions. From our perspective nearly three decades later, we can see that the joint drafting of such a plan was another example of how the unique institutional arrangement A.I.D. set up helped to facilitate its close role in implementing a Presidential decision to promote exports.

JAMAICA 1983-91: THE TAX REFORM PROPOSAL

In the early 1980s, Jamaica began to implement reforms in response to A.I.D.'s policy advice and to cash transfers accompanied by specific written conditions.[179] Gradually, Jamaica lowered tariffs, removed price controls, reduced food subsidies, and privatized a number of state-owned enterprises.[180] The results were impressive: GDP growth rate since 1988 has averaged above 3 percent, non-traditional exports have risen an average of 30 percent in the last five years, and over 100,000 jobs were added after 1985. By 1993, the size of Jamaica's formal economy had been restored to the peak level it reached in 1973.

This case focuses on fiscal reform. Ideally, no government should have an excessive (over 5%) budget deficit. This requires both limiting expenditures and establishing a fair and efficient system of taxation to raise revenues without their becoming a drag on economic growth. Jamaica lacked both an efficient tax system and a fiscal policy analysis unit in the Finance Ministry. A.I.D. tackled the tax issue in 1983, and the policy analysis unit in 1993.

In 1983 A.I.D. financed a team of tax experts to work with the government of Jamaica for nearly a decade at a cost of nearly $5 million. The goal was tax simplification and to set up a more efficient tax collection system without increasing tax rates. The A.I.D. Project Paper stated that the studies should include both drafting the legislation and performing the training to implement the new system. The Project Paper also made clear that "the inability of the tax structure to finance current expenditures and debt service. . . shares direct

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[179] This case is based on interviews in Jamaica conducted June 24-26, 1993 with the Chairman of the Revenue Board Edwin Tulloch-Reid and his staff; the Finance Secretary of the Finance Ministry, Shirley Tyndall; the primary A.I.D. long-term consultant on the reform Matt Bourgoise; with Betty-Ann Jones-Carr, a member and acting chairman of the committee that created the tax reform; and A.I.D. economist Sam Skogstad, who provided described his role at the beginning of the reform. Charles Mohan, Mission Economist, also contributed.

[180] Jane Harrigan, "Jamaica," in Paul Mosley, Jane Harrigan, and John Toye, Aid and Power: The World Bank and Policy-Based Lending, Volume 2, Case Studies , London: Routledge, 1991, pp. 311-320.

responsibility for the present poor performance of the economy."[181] By 1985 the A.I.D. plan, as modified by Jamaica, began to be implemented on a multi-year schedule. Later, A.I.D. assisted the new tax system by providing computers.

This was not an easy time for Jamaica. Under Prime Minister Seaga, price controls were removed and government enterprises were divested; but, according to A.I.D., "the quality of tax administration has deteriorated to a point where an unacceptably small proportion of the tax base is being assessed, harming economic growth."[182] There were large demonstrations in January 1985 protesting the rise of gasoline prices caused by the fall in value of the Jamaican dollar. Then the Alcoa bauxite processing facility closed in February 1985.

These incidents came after a period of steady growth in the 1960s and early 1970s followed by a sustained decline that saw real per capita GDP fall by 20 percent between 1973 and 1980. Unemployment reached 27 percent in 1980. Foreign exchange reserves were exhausted. Perennial budget deficits and inflationary financial policy brought Jamaica to near financial collapse.

To reform the tax structure without creating disincentives to economic growth, one possibility A.I.D. foresaw for Jamaica was a value-added tax (VAT). The VAT is a relatively new type of tax; no nation had such a tax in 1950. But by 1988 over 60 nations had a VAT, including almost 20 less-developed nations that had adopted it since 1984.[183]

The opposition Jamaica Labor Party won an overwhelming parliamentary majority in the 1980 elections and a mandate to deregulate the economy, stimulate the private sector and

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[181]U.S.A.I.D., Jamaica Project Paper, Revenue Board Assistance, 1983, PD-AAN-562; U.S.A.I.D., Jamaica Project Paper, Amendment No. 1, July 1986, PD-AAU-247; U.S.A.I.D., Jamaica Project Paper Revenue Board Assistance Amendment No. 2, September 1989, PD-KAT-852.

[182]T. Dwight Bunce, Evaluation of the Board of Revenue Assistance Project for U.S.A.I.D./Jamaica, March 1985, XD-AAR-463-A, attached to PD-AAR-463.

[183]Glenn P. Jenkins, "Tax Reform: Lessons Learned," in Reforming Economic Systems in Developing Countries, edited by Dwight H. Perkins and Michael Roemer, Harvard University Press, 1991.

switch to an export promotion strategy. In 1981 the new Seaga government's economic recovery program made impressive progress, and foreign investment and foreign aid increased sharply. The overall budget deficit declined from 14 percent of GDP to 12 percent. But the world market for Jamaica's major foreign exchange earners (bauxite and alumina) contracted, as did the important tax revenues provided by these commodities.

The new government of Jamaica suggested that the fiscal shortfall could be offset with comprehensive tax reform. Jamaicans needed a reform that would not slow economic growth. Prime Minister Seaga made this question a high priority on his policy agenda. The Finance Ministry asked A.I.D. for help.

A.I.D.'s efforts to assist Jamaica with tax reform came in the context of tax reforms several years earlier in other countries, but there were some pioneering aspects to the idea as applied in Jamaica.

In successful tax reform, the national leader and the finance minister must play vital roles. In Jamaica, the Prime Minister assumed the job of finance minister as well. The key ingredient in A.I.D.'s success in tax reform in Jamaica was the way that the reform proposals were developed. The reform was not the result of pristine or rigid cookie-cutter recommendations delivered by a set of foreign experts. Instead, the Jamaicans who were to implement the reforms (in the Finance Ministry's newly created Board of Revenue) were heavily involved in the analysis and preparation of the tax proposals and the necessary legislation. A.I.D. helped them not only by providing technical expertise but also by working with them to navigate around institutional constraints over several years. Great care was taken to present studies and analysis to key Jamaican officials over many years. 37 formal staff working papers were prepared as well as other policy memoranda.[184]

The A.I.D. team recognized that there was more than one way to design a tax system. The solutions to taxation issues had to take into account the political and administrative situation as well as the possible adjustment cost of adopting a new tax system. A.I.D. realized that, of all a nation's governmental institutions, the national tax system affects the largest

[184]Jenkins, p. 296.

share of the voters.[185]

Jamaica's tax reform included a tax cut in the marginal tax rate on individual income tax from 58% to 33%, a cut in corporate income tax rate from 45% to 33%, and the implementation of a value-added tax with a single tax rate. Jamaica's income tax revenue had declined in real terms from $126 million in 1978 to $110 million 1981.

Initially, many feared that a value added tax would be regressive and hit the poor harder than the rich. This turned out not to be true for Jamaica or other developing nations. The reason is that a large proportion of expenditures by the poor in any developing nation are for unprocessed food and items sold directly by very small enterprises. It is not feasible to collect value-added taxes on items like this that are not in the modern retail chain, so most of the expenditures by the poor are not affected by such a tax, or can be exempted by law.

Another strong influence on officials in Jamaica was to learn that the European Community requires adopting a value-added tax for membership.

The value-added tax also provided the Jamaican government the opportunity to introduce computerization in tax administration. The microcomputer permits a revolutionary improvement in tax administration in less-developed countries. Taxpayer compliance may be higher if notification to taxpayers about arrears or other problems are rapid. This became possible with microcomputers in the 1980s that represent computing power that would have cost tens of millions of dollars in the 1960s.

THE INSTITUTIONAL IMPLEMENTATION OF THE VALUE-ADDED TAX

The Finance Secretary of Jamaica has called the A.I.D. tax reform project "one of the best foreign aid projects ever carried out in Jamaica."[186] Yet the specific economic impact of the reform has been found almost impossible to measure yet.[187] The main reason has been the

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[185]Interviews in 1992 with A.I.D./Jamaica economist (in 1983) Sam Skogstad and A.I.D./Washington/PPC economist (in 1983) Paul O'Farrell.

[186] Interview in Jamaica with Finance Secretary Shirley Tyndall, June 25, 1993.

[187] Kenneth Hubbell, Alfred Francis, and Richard McHugh, Evaluation of USAID/Revenue Board Assistance Project for USAID Mission in Jamaica, March 31, 1992, p.

economic turmoil unrelated to tax reform. First, in 1988 two years after the flat income tax was introduced, Hurricane Gilbert caused nearly one billion dollars damage and devastated tourism, Jamaica's main source of foreign exchange. Second, in 1991 inflation reached historically high levels of 80 percent, while during that year the Jamaican dollar was allowed to devalued by 70 percent. Interest rates exceeded 50 percent, and real incomes for wage earners declined substantially.[188] Third, the world prices of Jamaica's main traditional exports including coffee and alumina continued to fall, leading to a growing balance of payments deficit because Jamaica depends so heavily on imports, which are 50 percent of GDP. Prime Minister Michael Manley resigned in March 1992, but his successor P.J. Patterson pledged to continue all the reforms leading toward a fully open market economy.

In spite of these economic events, the share of GDP of all taxes rose from 21.6 percent in 1985 (before the flat income tax reform) to an average of nearly 28 percent from 1987 to 1991, according to Revenue Board statistics, an increase of nearly one-quarter. Thus, fears that reductions in income tax rates would lead to reduction in revenues were misplaced, which is significant because individual income taxes account for 30 percent of Jamaican government revenues.

The tax structure changed in October 1991 when the government implemented the VAT or GCT. The institutional mechanism that drove the tax reform deserves a close examination. It probably accounts for the success the reform enjoyed.

As mentioned earlier, in 1983 A.I.D. responded to a request by providing tax experts not directly from A.I.D., but from funded as a project with Syracuse University. In retrospect, this approach seems to have avoided a major difficulty. Jamaican officials point out that A.I.D. and the Unites States never became a party to the controversy over tax reform. Instead, the Jamaican press and members of Parliament referred to the "Revenue Board tax project"

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5 states this evaluation was to "answer" the question "Did the project promote recovery and broad-based growth in the Jamaican economy?" However, p. 8 states, "There is no compelling reason to claim that tax reform has had an overwhelmingly positive or negative effect on overall economic activity in the country."

[188] Program Objectives Document and Action Plan FY 1993/94, USAID/Jamaica, May 1992, p. 1.

rather than to foreign pressure. From 1983 to 1985 the Revenue Board performed the critical task of defining the scope of the tax reform package, but recommended that legislative changes be shaped by an independent Tax Reform Committee. The Board and the Syracuse experts recommended the VAT concept, but it never was seen as U.S. pressure. The Revenue Board Chairman expressed his appreciation that A.I.D. funded "the Rolls Royce of tax experts," but said that in private meetings and public discussions, these experts were never perceived to be U.S. governmental representatives, but rather to be academic tax specialists working for the Board.[189]

A second factor stemmed from the Prime Minister's decision after he heard the results of the first two years of studies and analysis by the Revenue Board staff and the A.I.D. specialists. This was the decision by Prime Minister Seaga to appoint an official Tax Reform Committee of 12 citizens from the most important interest groups in Jamaica. Both labor unions were represented, as was the private sector, and experts from the legal, banking and accounting professions. The first chairman was a distinguished academic who hosted the meetings at the University of the West Indies of which he was president, thereby providing a scholarly and non-partisan atmosphere.

A third factor appears to have been the high quality of the dialogue among the members of this Tax Reform Committee.[190] Literally hundreds of alternative tax plans were considered and evaluated in terms of their impact on interest groups and economic growth, with the help of the A.I.D.-funded advisers. The chairman and the business representatives gradually persuaded the labor union representatives that the pre-reform tax system actually benefited the wealthy because of the numerous income tax deductions available only to them. Jamaican politics is dominated by two parties each of which is supported by a labor union federation. Apparently, when the income tax reform law easily passed both houses of the Jamaican legislature, sophisticated observers realized the labor unions had supported reductions in the marginal tax rate that appeared to benefit the rich.

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[189] Interview with Revenue Board Chairman Edwin Tulloch-Reid, March 23, 1993.

[190] Interview with Betty-Ann Jones-Kerr, Peat Marwick Jamaica, March 24, 1993. Jones-Kerr served on the Tax Reform Committee, and was for a time its acting chairman.

A fourth factor in 1986 was that the Tax Reform Committee's final report to the Jamaican Parliament formally recommended the Value Added Tax, thus setting the stage for its implementation in 1991.During this five year delay in implementing the VAT, A.I.D. continued to support the VAT concept. After his election in 1989, Prime Minister Manley appointed a news Tax Reform Committee, which soon recommended the VAT and described precisely how it should be implemented. A.I.D. finally made it an explicit condition of further aid in 1990, as did the World Bank and the IMF. In 1990 a member of the Tax Reform Committee from the beginning Betty-Ann Jones-Kerr was seconded from Peat Marwick to be a special assistant to the Finance Minister in order to expedite the drafting of the VAT legislation. This move overcame a crucial obstacle. Policy reforms can be bogged down in the final implementation phase, which in this case was slowed for many months due to the absence of technical tax law drafting expertise. A.I.D. supported this phase, too, and when the project was ended in 1991, the Revenue Board hired the A.I.D. consultant itself.

To understand fully the implementation of the Jamaican tax reform requires an appreciation of the larger economic context in which A.I.D. was operating. From 1973 to 1980 after years of protectionist policies and social experiments, the Jamaican government's share of GDP had increased from 25 to 43 percent. The fiscal deficit reached 17 percent. Foreign debt reached $4 billion, among the world's highest per capita debt ratios for a population of 2.3 million. Policy reform began to turn all this around in the 1980s as a result of the conditionality provisions of A.I.D.'s cash transfers and technical assistance, but a small developing country like Jamaica "lives or dies" on world demand for its exports. Bauxite/alumina made up over 70 percent of export earnings. Jamaica fell from a peak of 75 percent of world bauxite production to only 7 percent by 1985, while the world price fell by 50 percent.

In these trying conditions, Jamaican economic policy had little room for error. Yet Jamaica not only lacked the expertise to analyze and reform its tax system, it also lacked a policy analysis unit on the expenditure side. This vacuum is now being filled with A.I.D.

assistance.[191] But it was highlighted in 1990 when an A.I.D. study revealed to the Jamaican Finance Ministry that the Bank of Jamaica had for many years been financing the central government deficit by selling forty-year bonds at zero interest to the government which the Bank financed at commercial interest rates. This operation permitted Jamaica to report a central government surplus. According to A.I.D.:

> Accommodation of Government debt by the Central Bank has contributed heavily to a more than five percent GDP loss by the Central Bank. . . .The Ministry of Finance has little analytical or operational expertise in debt structuring or management. If there are no fiscal parameters applied to borrowing decisions, there is simply no internal discipline over spending, and this is precisely why Jamaica acquired one of the world's largest per capita debts without generating a strong economic base.[192]

Some Jamaican officials had the illusion that deficit financing was interest free. This problem was identified as Jamaica was steadily improving its economic policies, but it illustrated the wisdom of A.I.D.'s decision to fund a fiscal policy analysis unit within the Finance Ministry. It reminds us that the main challenge faced by A.I.D. and the developing nations may not always be prescribing or implementing economic reforms, but actually the more fundamental problem of diagnosis -- identifying what reforms are needed and in the long term establishing the capacity in developing nations to analyze themselves.

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[191] "The successful Revenue Board Assistance project is well accepted by the Ministry of Finance, and will likely serve as a model for future assistance to this Ministry," according to Project Paper 532--164, Policy Reform in Support of Private Investment, ESF Cash Transfer, September 1991, AID/LAC/P-662, p. 13.

[192] Ibid.

COSTA RICA 1983-93: CASH TRANSFERS AND COVENANTS

A.I.D.'s role in economic policy reform in Costa Rica in the 1980s was a vigorous one.[193] A.I.D.'s success can be seen in both Costa Rica's GDP growth rate (4.2 percent annual average from 1983 to 1992) and its more dramatic average annual increase in non-traditional exports (28 percent since 1983). These growth rates represent a successful recovery from the difficulties of 1981-82. They also reflect major economic policy changes A.I.D. persuaded Costa Rican economic leaders to adopt. Some critics of economic reform claim that its "austerity" can harm the poor, but in Costa Rica the improvement of household income from 1980-89 following the adoption of reform measures was greatest for the lowest income brackets, probably because labor-intensive businesses employing the poor benefited from increased incentives for exporting.[194]

Before the world recession and the sharp rise in oil prices in 1980-82, Costa Rica's economy had grown for two decades at an annual rate of 6.5 percent.While not impressive by the standards of Taiwan and Korea, this was a high growth rate by Latin American standards. However, it concealed four structural weaknesses in the Costa Rican economy that became especially important once the world economy began to change radically in 1980:

1) Costa Rica depended largely on four traditional agricultural exports of bananas,

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[193] This case study is based on interviews in Costa Rica from March 8-15, 1993 with A.I.D. Mission officials and Minister of Finance Rodolfo Mendez-Mata, Minister of Planning Vargas Pagan, Minister of Commerce Roberto Rojas, Vice President Arnoldo Lopez-Echandi, former Central Bank President (1984-1990) Eduardo Lizano, former Vice President Jorge Manuel Dengo, Presidential candidates Jose Figueres and Jose Miguel Corrales, and several professional economists and former ministers, including Thelmo Vargas and Carlos Castillo, former Planning Minister Otton Solis, former National Assembly President Rodolfo Solano, and Planning Ministry official Sylvia Saborio.

[194] Methodological problems in such estimates are noted in Clarence Zuvekas, Jr., Costa Rica: The Effects of Structural Adjustment Measures on the Poor, 19982-1990, Staff Working Papers No. 5, June 1992, Agency for International Development, p. 1. See also Annex B, "Costa Rica: The Effects of Structural Adjustment Measures on the Poor, 1982-1990," in Program Assistance Approval Document, Trade and Investment II, Project No. 515-0260, A.I.D. Mission, Costa Rica, March 4, 1992, PD-ABD-842, p. 107.

coffee, beef, and sugar;

2) Costa Rican industry was weak because it had been sheltered too long from competition behind the tariff walls of the Central American Common Market;

3) the Costa Rican private sector had been unable to develop freely because of unwise government intervention in the economy in the form of price controls, subsidies, public sector corporations, and a nationalized banking system;

4) the fiscal deficit, which averaged 13.5 percent of GNP in 1980-81 was fueling inflation and further distorting the price structure; and

5) much of Costa Rica's growth in the 1970s had been fueled by heavy borrowing from foreign commercial banks.[195]

In July Costa Rica suspended payments on its debt to commercial bank creditors. Its per capita debt by this time exceeded that of the more publicized cases of Brazil and Mexico. Per capita GDP declined during 1981-83 by a cumulative 16 percent.

From 1982 to 1988, A.I.D. made large cash transfers to Costa Rica totaling $800 million, more than the amount of loans provided by the IMF and World Bank. A.I.D. cash transfers averaged 3.8 percent of the GNP and reached as high as 5 percent.[196]

These A.I.D. cash transfers had written conditions tied to economic policy reforms. The cash transfers were paid into a separate account and not commingled with the regular budget. Each year an "ESR" (Economic Stabilization and Recovery) agreement specified the economic policy reforms to be undertaken, known as "covenants." Nearly half of the ESR covenants were aimed at the financial sector, with 33 of the 105 covenants from 1982-87 relating to the Central Bank of Costa Rica where reforms were requested to allocate more loans to private enterprise, to end rigid controls on interest rates, and to liberalize the banking system. ESR covenants also requested export promotion and privatization of inefficient

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[195] Eduardo Lizano, Economic Policy Making: Lessons from Costa Rica, Occasional Papers No. 21, International Center for Economic Growth, San Francisco: ICS Press, 1991.

[196] Costa Rica is about the size of West Virginia with a population of nearly 3 million. Per capita cash transfers by A.I.D. from 1982-87 averaged $55, compared to an average per capita GDP of $1500 then.

government-controlled enterprises, especially covenants requiring that the state holding company, CODESA, sell its holdings in specific enterprises like a cement plant, an aluminum plant, and a sugar refinery.

Costa Rica had maintained price controls on many commodities, so covenants also required that wasteful agricultural subsidies must be cut. Additional covenants called for tariff reductions, which were to be cut in half from a 75 percent average effective rate of protection. Covenants also required that a private sector investment promotion agency was established called CINDE, Coalition for Development Initiatives.

Costa Rica, with advice and funds from A.I.D., made a significant recovery from the crisis years of the early 1980s and gradually liberalized its economy. Indicators of income, wages, and employment have shown significant gains and income inequalities have narrowed, in spite of the fact that coffee prices are the lowest in 30 years. The fiscal deficit fell from nearly 14 percent of GDP in 1981 to only 1.6 percent by 1986, and fiscal surpluses were recor. . in 1991 and 1992.

THE INSTITUTIONAL PHASE OF POLICY REFORM[197]

By 1989, Costa Rica had the strongest recovery in Central America from the continuing economic crisis that began in the late 1970s, which surpassed the depression of the 1930s in length and in some countries in severity.[198] However, Costa Rica's GDP growth rate still lagged behind its performance in the 1960s and 1970s, and its per capita GDP in 1989 remained 5.4 percent below the 1979 peak. Many major distortions in the Costa Rican economy had been reduced, but there were still challenging problems. A.I.D. decided to press

[197] The Effectiveness and Economic Development Impact of Policy-Based Cash Transfer Programs: The Case of Costa Rica, A.I.D. Evaluation Special Study No 57, November 1988, Washington, D.C. PN-AAX-210.

[198] Clarence Zuvekas, Jr., "Alternative Perspectives on Central American Economic Recovery and Development," Latin American Research Review, p. 126 states that Costa Rican growth for the 3 year period 1987-89 was 3.7 percent, in Honduras it was 3.5 percent, El Salvador from 1983-1989 averaged only 1.6 percent, and Nicaragua fell annually by 3.1 percent from 1983-89.

ahead with additional reforms, based on the foundation laid in the 1980s.

One key problem was to consolidate and institutionalize the reforms and the new economic strategy behind them. Costa Rica's economic strategy in the 1960s and 1970s was traditional agricultural exports (coffee, bananas, sugar, beef) and import-substitution industrialization through membership in the Central American Common Market. It has been demonstrated that this strategy not only increased vulnerability to external events (like rising oil prices and interest rates, and falling commodity prices) and aggravated income inequalities.[199] The "winners" were the large and medium scale farmers engaged in exporting and industrialists benefiting from tariff protection, cheap credit, tax advantages and other subsidies. A.I.D. advised the Costa Rican authorities to move toward a new strategy that would yield higher growth rates and reduce income inequalities in the new international economic environment -- "nontraditional" export diversification, tariff reduction, price liberalization, subsidy reduction, expansion of private banking, and deficit reduction by reducing the public payroll.

In May 1990 the new President Calderon and his cabinet reassured A.I.D. they wished to continue the reforms. As a sign of strength, Costa Rica (within the Brady Plan framework) purchased almost $1.0 billion of its commercial debt at a price of 16 percent of the par value of the debt and a favorable interest rate (6.25%). Then, in November 1991 at an A.I.D.-financed seminar, President Calderon reaffirmed his commitment to trade liberalization and to reduction in the size of government. Could he succeed by 1994? The implementation would be the challenge. One key would be the strength of A.I.D.'s local allies.

The strength of pro-reform institutions is still a controversial subject in Costa Rica, especially because many of them were created with A.I.D. funds outside the government. There has been an effort to suggest that the reforms are "Made in America"and therefore tend to discredit the proud model established in Costa Rica in the 1947 of democracy, no army and a state-controlled economy.

But did Costa Rica really "import" its reforms completely from the United States?

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[199] Victor Bulmer-Thomas, The Political Economy of Central America Since 1920, New York: Cambridge University Press, 1987.

Interviews in Costa Rica with former senior economic officials suggested that in 1982 they had already identified the economic distortions that needed to be eliminated, before A.I.D. proposed cash transfers and covenants. They did not depend on A.I.D. for their diagnosis. Instead, they persuaded A.I.D. to support their policy reform strategy, not the other way around. In this view, a few Costa Rican economists and political leaders shrewdly employed A.I.D. to "take the heat" for a decade of structural reforms, rather than accept the risk themselves. They did this because of factional politics in the leading political party in the 1980s, which was divided on economic policy. These observers suggest that the reformist institutions A.I.D. established were useful to Costa Rican leaders to get around the widespread public pride in the state-controlled economy set up after 1947. They could claim that $800 million of United States aid depended on making economic policy changes. If this view is correct, Costa Rica's reforms will be sustained even as U.S. aid declines sharply in the 1990s.

Many Costa Ricans may be unaware of the role their economists played. One Presidential candidate interviewed in March 1993 for this study claimed, if elected President, he would investigate A.I.D.'s "illegal" bypassing of the National Assembly throughout the 1980s. The local media for several years have featured allegations that A.I.D. established a "parallel state" or shadow government through which foreign aid has been channelled outside the regular government ministries and without explicit authorization of the National Assembly. A.I.D.'s allies in the government of Costa Rica deny the allegation, responding that no law prohibited the foundations that A.I.D. funded nor was explicit National Assembly approval required.

This controversy may be alive now after nearly a decade of reform mainly because President Calderon wishes to press ahead with the kind of institutional reforms his own economic advisers (and A.I.D.) have been advocating. There are three: trade reform, price reform and, by far the most challenging, "reform of the state."

According to a memorandum written by deputy Mission Director Doug Tinsler, "Costa Rica is now entering the most difficult stage." Tinsler wrote:

> This is not to minimize the importance of past and future macro-economic adjustment policies, but rather the reality that exchange rates or tariff levels can be adjusted by the administration largely by fiat without too much fear of organized public protest from public sector labor unions or the need for Assembly Approval. This, however, is

not the case when it comes to the next phase of structural adjustment which, if it is to be successful, must confront and resolve a broad range of institutional issues that collectively contribute, in a major way, to the unacceptably high level of current expenditures, which , in turn, force drastic reductions, year after year, in the capital account and contribute to the chronic fiscal deficit.

The first issue, trade reform, benefits from the past decade of reforms, especially devaluation of the exchange rate and the increases in private banking credit to nontraditional exporters. The government has enacted tariff reductions to reach a maximum of 20 percent by the end of 1993 for almost all items. Inter-agency cooperation has also already established a "one stop" export document processing "window," thus resolving a frequent complaint of small-scale exporters. All surcharges and other taxes on exports are expected to soon be eliminated.

Second, the issue of price controls also is well advanced. Nevertheless, from the early 1950s until mid-1992, products sold at retail had price controls. Prices were fixed for 16 categories (reduced to 11 in 1992), and maximum markup margins were also fixed. Agricultural product prices were fixed, until President Calderon signed decrees abolishing fixed prices on beans, maize and rice in July 1992 and abolishing export licensing requirements for these crops. Under the FY 1992 ESF conditionality, A.I.D. could be credited for these reforms because A.I.D. had required that 60 percent of all the remaining controlled prices be eliminated as a condition of disbursement. An IBRD Agricultural Sector Loan also requires the elimination of price controls on basic grains as a principal condition.

The third issue is by far the most challenging. It is known euphemistically as "reform of the state" and implies both restructuring of the central bureaucracy and privatization of state enterprises. It has four components: 1) reforming the budget-making process, 2) privatization of government activities, 3) voluntary civil service reductions of 25,000 workers or 15 percent of the public sector labor force, 4) banking reform. A.I.D.'s efforts here can cap the success of the past decade, and there has been significant progress.

Budget reform will require institutional changes. Only 30 percent of the annual national budget passes through the legislature. 70 percent finances the so-called decentralized and autonomous institutions managed independently by the Controller General. With assistance from A.I.D., an inter-agency team has put in motion a systematic effort. An innovative project seeks to modernize the staff system of the National Assembly as well as establish a unified budgetary process among the several arms of the executive branch.[200]

Public sector efficiency includes privatizing parts of five central ministries. The CNP, or National Grains Production Board, in the mid 1980s was responsible for 40 percent of the losses of the public sector. Ideally, it should be dissolved, but it has partisan and labor union support as a symbol of the golden age of the welfare state.A.I.D. has funded the two key reductions so far that are hollowing out CNP. First, the Calderon Administration's most successful privatization effort (of 157 state-run retail stores managed by CNP) was accomplished by FINTRA, the A.I.D.-financed assets trust responsible for the divestiture of 42 state companies managed under the state holding company, CODESA. In 1991, the CNP stores were spun off along with 750 civil servants to form six regional cooperatives.

Ironically, CNP's central source of power and revenue is its importation and management of PL 480 food aid. Thus, in 1992, A.I.D. informed the government of Costa Rica that it would follow the precedents in El Salvador and Honduras to run the PL 480 program through the local private sector.[201] A.I.D. and the Government of Costa Rica decided to give no new functions to CNP a to give a specific definition to its publicly accepted role of managing a national emergency grain reserve.

In 1992, there was another successful A.I.D. initiative in public sector efficiency, known as the "reform of the state." The Calderon Administration, driven by a forecast of a 7 percent fiscal deficit, attempted to commence involuntary reductions-in-force of public sector employees using severance payments from local currency associated with the A.I.D. program. Widespread opposition from the unions and the opposition party culminated in a successful

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[200] The Consortium for Legislative Development received a three year grant from A.I.D. to work with legislatures in Latin America, including Costa Rica, Nicaragua and Haiti, to "build its institutional capacity to effectively perform its constitutionally assigned functions," inluding support to the Central American Association of Legislative Staff, according to the Master Plan for the Development and Modernization of the Legislative Assembly, Republic of Costa Rica, April 15, 1991.

[201] A.I.D./Costa Rica Deputy Mission Director Doug Tinsler referred to this decision as "cutting the heart out of the CNP."

challenge in the Supreme Court. The Administration changed tactics and created, with A.I.D. assistance, a private foundation (FUCE) to handle the severance process and to enable civil servants to receive payments within thirty days of their announced intention to resign. 9,000 civil servants took advantage of the program up to 1992. Some officials want the program to reach 15 percent of the public sector labor force, or 25,000 workers, in order to balance the budget, through severance payments and privatization initiatives. Such a reduction is small, given that the 160,000 public employees make up 20 percent of the labor force, and have grown from only 36,000 in 1962, with pension plans funded by taxes and with salary levels above the private sector.

A.I.D. decided to assist the Calderon Administration's ambitious privatization agenda, but actual progress has been difficult. The main success was the privatization of the CNP retail stores network,which pales in comparison with the additional divestitures proposed to the National Assembly, namely the state fertilizer company and the state cement company. These two companies constitute the key remaining assets of CODESA, the state holding company, which has been the subject of a decade long A.I.D.-supported privatization program. The Controller General has ruled that legislation is required before the government can authorize FINTRA to prepare the companies for sale. Following these divestitures, A.I.D. and the government have signaled that next will come the state insurance monopoly and the state alcohol monopoly.

It is interesting to note which potential reforms are still considered to be in the "too hard to do" basket. The 1947 Figueres "model" of a social welfare state has been modified by a decade of reform. Yet the four national-owned banks cannot be considered for privatization. The opposition party's support would be needed to obtain an absolute majority in the Assembly to approve another World Bank structural adjustment loan, and it is widely thought that privatizing state banks would be too much for the opposition party. Current banking law does not even permit the Central Bank to offer rediscount facilities to private banks. As a partial measure, A.I.D. agreed to the use of local currency funds to establish a rediscount facility in the Central Bank, which was permitted under Costa Rican law. Yet another distortion in the economy had been reduced with A.I.D. assistance. Nevertheless, the financial sector is not efficient when government can direct most banking credit to its favorites and when the Central Bank is not legally independent. Budget and financial reforms will be on the future agenda for this more challenging institutional phase of economic policy reform.